91-877

(2)

No. 91-

In The

Supreme Court of the United States

October Term, 1991

ERNST & YOUNG,

Petitioner,

v.

BOB REVES, ET AL.,

Respondents.

Petition For Writ Of Certiorari To The United States Court Of Appeals For The Eighth Circuit

APPENDIX TO PETITION FOR A WRIT OF CERTIORARI

VOLUME I

JOHN MATSON
(*Counsel of Record*)
CARL D. LIGGIO
ELIZABETH B. HEALY
380 Madison Avenue
New York, New York 10017
(212) 773-3910

KATHRYN A. OBERLY
DANIEL M. GRAY
1200 19th Street, N.W.
Washington, D.C. 20036

FRED LOVITCH
4705 Central Avenue
Kansas City, Missouri 64112

Attorneys for Petitioner

COCKLE LAW BRIEF PRINTING CO., (800) 225-6964
OR CALL COLLECT (402) 342-2831

TABLE OF CONTENTS

TABLE OF CONTENTS – Continued

APPENDIX A

United States Court of Appeals

FOR THE EIGHTH CIRCUIT

No. 87-1726WA

Arthur Young & Co.,	*	Appeals and
Appellant,	*	Cross-Appeal
	*	from the
v.	*	United States
Bob Reves; Robert H. Gibbs;	*	District Court
& Frances Graham,	*	for the
	*	Western District
Appellees.	*	of Arkansas
	*	

No. 87-1727WA

Thomas E. Robertson, Jr., *
As Trustee of the Farmer's *
Co-op of Arkansas and Oklahoma,*
Inc., and as representative *
of a class of members, depositors, *
and equity security holders, who *
are similarly situated to him; *
Bob Reves; Frances Graham; Robert *
H. Gibbs, individually; Robert H. *
Gibbs, as natural guardian of his *
minor children, Thomas A. Gibbs *
and Robert H. Gibbs, Jr.; and *

Robert H. Gibbs, as Trustee of the Muskogee Internal Medicine Group Profit Sharing Funds, *

Appellants, *

v. *

Arthur Young & Co., *

Appellee. *

No. 87-1803WA

Thomas E. Robertson, Jr., As Trustee of the Farmer's Co-op of Arkansas and Oklahoma, Inc., and as representative of a class of members, depositors, and equity security holders, who are similarly situated to him, *

Appellees, *

v. *

Arthur Young & Co., *

Appellant. *

No. 87-2533WA

Thomas E. Robertson, Jr., etc., et al. vs. Jack White, et al. *

Thomas E. Robertson, Jr., As *
Trustee of the Farmer's Co-op *
of Arkansas and Oklahoma, Inc., *
and as representative of a *
class of members, depositors, *
and equity security holders, *
who are similarly situated to *
him; Bob Reves; Frances Graham; *
Robert H. Gibbs, individually; *
Robert H. Gibbs, as natural *
guardian of his minor children, *
Thomas A. Gibbs and Robert H. *
Gibbs, Jr.; and Robert H. *
Gibbs, as Trustee of the *
Muskogee Internal Medicine *
Group Profit Sharing Funds, *
*
Appellees, *

v. *
*
Arthur Young & Co., *

Appellant. *

No. 88-1014WA

Thomas E. Robertson, Jr., etc., *
et al. vs. Jack White, et al. *
*
Robert R. Cloar, Class Counsel, *

Appellant, *
*
v. *

Bob Reves, *
*
Appellee. *

Submitted: March 12, 1991

Filed: June 27, 1991

Before FAGG, Circuit Judge, SNEED,* Senior Circuit Judge, and MAGILL, Circuit Judge.

MAGILL, Circuit Judge.

* THE HONORABLE JOSEPH T. SNEED, Senior Judge, United States Court of Appeals for the Ninth Circuit, sitting by designation.

Arthur Young appeals from the district court's entry of judgment against it after a jury found that the firm had violated both federal and state securities laws.[1] On

---

[1] This appeal is before us on remand after the Supreme Court reversed our earlier decision that the financial instruments at issue in this case were not federal securities. *See Reves v. Ernst & Young*, 110 S. Ct. 945 (1990), *rev'g Arthur Young & Co. v. Reves*, 856 F.2d 52 (8th Cir. 1990). We had ruled that the instruments were not federal securities under the test from *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). *See* 856 F.2d at 55. The Supreme Court, however, declined to apply the *Howey* test,

(Continued on following page)

appeal, Arthur Young argues that the district court erred in (1) certifying the plaintiff class; (2) holding that the financial instruments at issue in this case were securities under Arkansas law; (3) denying its motion for judgment notwithstanding the verdict on the state and federal securities claims; and (4) denying its motion for a new trial on the ground that a requested instruction on contribution was not given to the jury. Arthur Young also argues that the damages awarded to the appellees were not supported by the evidence and challenges the district court's awards of attorney fees, costs, and interest to the appellees. On cross-appeal, Reves and Robertson challenge a number of the district court's rulings, including its dismissal of Robertson's breach of contract claim, its granting of summary judgment in favor of Arthur Young on Reves, RICO claim, its crediting of settlement proceeds against the jury's verdict, and its decision on fees for Reves' counsel. We affirm in part and reverse in part.

I.

A. The Co-op

The facts of this case involve the Farmer's Cooperative of Arkansas and Oklahoma, Inc. (Co-op), which was organized in 1946 and operated in western Arkansas and eastern Oklahoma. Any farmer in the area could become

---

(Continued from previous page)

and instead applied the Second Circuit's "family resemblance" test, *see, e.g., Exchange Nat'l Bank v. Touche Ross & Co.*, 544 F.2d 1126 (2d Cir. 1976), to conclude that the instruments were securities under federal law. 110 S. Ct. at 952.

a member, and as a member was entitled to one share and one vote. Each year the Co-op's members elected twelve of their own to serve on a Board of Directors. The Board met monthly to review the Co-op's operations, but delegated actual management of the Co-op to a general manager, whom the Board appointed. In 1952, the Board named Jack White as general manager. White served in that capacity until the Board removed him in mid-1982.

To raise money for its operating expenses, the Co-op sold promissory notes payable to the holder on demand. These demand notes, while uncollateralized and uninsured, were nonetheless attractive to investors because they paid a higher interest rate than that local financial institutions offered. The Co-op advertised the demand note program in its monthly newsletter as an "Investment Program." The advertisement stated the rate of interest the notes would earn and claimed: "YOUR CO-OP has more than $11,000,000 in assets to stand behind your investments. The Investment is not Federal [sic] Insured but it is . . . Safe . . . Secure . . . and available when you need it. Interest is computed to the day of withdrawal." *See, e.g.*, Joint Appendix (JA) at 1820 (ellipses in original).

B. The Gasohol Plant

In 1979, the Co-op's general manager, White, joined with entrepreneur Edwin Dooley to finance and construct a gasohol plant. Dooley and White each invested $125,000 of their own funds and as a result each owned half of the enterprise, which was known as Big D & W Refining and Solvents, Inc. Dooley served as president of the corporation; White was its secretary. Construction of the plant

began in June 1979. Four months later, White, financed by a loan from the Citizens Bank & Trust Company (Citizens Bank), purchased Dooley's interest in Big D & W and renamed the company White Flame Fuels, Inc. (White Flame).

Beginning in January 1980, White obtained loans from the Co-op to finance the continued construction and the initial operation of the gasohol plant. White personally guaranteed these loans. The plant finally began producing gasohol the following April, but was soon beset by problems stemming from the plant's poor design and outside economic factors. White continued to obtain loans from the Co-op; by December 1980, these loans totalled approximately $4 million.

In September 1980, White was indicted for federal tax fraud. The indictment charged, among other things, that White had engaged in a course of self-dealing with the Co-op and had filed fraudulent tax returns. Also indicted with White was Gene Kuykendall, the Co-op's longtime accountant, who was also White Flame's accountant at this time.

Shortly after the indictment, at a November 12, 1980, Board meeting, White proposed that the Co-op purchase White Flame. The Board agreed and voted to acquire the company. One month later, however, the Co-op filed a declaratory action against White and White Flame in state court. The complaint had been drafted by White's attorneys, and alleged that on February 15, 1980, White had told the Board that all of White Flame's stock would be transferred to the Co-op in exchange for the Co-op's assumption of White's debts to the Co-op and Citizens

Bank.[2] The complaint alleged that in reliance on this agreement, the Co-op invested further sums in White Flame, based on the assumption that it owned the company. The complaint next alleged that White did not transfer the stock as agreed, and that the Co-op had not executed a note assuming White's debts to Citizens Bank. Based on these allegations, the Co-op sought a declaratory judgment stating that the Co-op had acquired White Flame on or about February 15, 1980; that the Co-op had assumed Jack White's debt to Citizen's Bank; that all amounts the Co-op lent to Jack White or White Flame before February 15, 1980, were investments in White Flame; and that Jack White was discharged from any debts to the Co-op relating to White Flame.

Shortly after the complaint was filed, White's attorneys sent the Co-op's attorney, Carl Creekmore, White's answer and a proposed consent decree. Creekmore filed the answer and obtained the state court's approval of the decree on December 19; but the decree was not filed until January 26, 1981. The decree provided that the Co-op had owned White Flame since February 15, 1980; that the Co-op had assumed White's debt to Citizen's Bank; and that White was discharged from any liability to the Co-op for loans for White Flame. The result of this friendly suit was that White was relieved of over $4 million of debt and that the Co-op owned White Flame as of February 15, 1980.

---

[2] The minutes of the Co-op Board Meeting for February 15, 1980, do not contain any references to the Co-op acquiring the stock of White Flame. JA at 933. In fact, the first reference to the Co-op purchasing White Flame does not occur until the minutes of the November 12, 1980, Board meeting. JA at 1070.

C. The 1981 Audit

Both White and Kuykendall were convicted of tax fraud in January 1981.[3] Testifying on White's behalf at the criminal trial was Harry Erwin, the managing partner of Russell Brown and Company, Arkansas' largest accounting firm at that time.[4] Shortly after White's conviction, his lawyer contacted a member of Russell Brown and stated that the Co-op was interested in hiring the firm. In June 1981, Jack White and Kirit Goradia, the Co-op's office manager, met with Erwin and Joe Drozal, another member of Russell Brown. Later that year the Co-op hired Russell Brown to perform the Co-op's 1981 audit. Joe Drozal was named the partner in charge; Joe Cabaniss was selected to assist him.

After beginning the 1981 audit process in early 1982, Drozal became aware that there were problems concerning how White Flame should be treated for accounting

---

[3] This court affirmed these convictions in *United States v. White*, 671 F.2d 1126 (8th Cir. 1982). The evidence in the criminal case showed that White had engaged in a course of self-dealing with the Co-op, and that he and Kuykendall had cooked the Co-op books and filed fraudulent tax returns to cover up White's activities. We concluded: "The record clearly demonstrates that White and Kuykendall manipulated the Co-op's finances to serve their own personal ends, and that they distorted the Co-op's records of receipts. . . . " *Id.* at 1134.

[4] On January 2, 1982, Russell Brown merged with Arthur Young and Company. After the merger, Erwin was placed in charge of Arthur Young's Arkansas practice. Later, Arthur Young and Company became Ernst & Young. For the sake of consistency with the earlier opinions in this case, future references will be to "Arthur Young."

purposes. In a January 26, 1982,[5] memo, Drozal raised several problems relating to the valuation and acquisition of White Flame. He observed that White Flame's records contained no detailed documentation of cost or expense allocations. Drozal also specifically noted that the Co-op's audited financial statement for 1980 had disclosed the Co-op's full ownership of White Flame, but had not disclosed that the Co-op had forgiven the $4 million in loans White had personally guaranteed. JA at 1189-91.

One of Drozal's first tasks in the audit was to determine White Flame's fixed asset value. Drozal realized that he could not rely on the fixed asset value provided for White Flame in the 1980 financial statement because Kuykendall, a convicted felon, had prepared that statement. Therefore, Drozal had to determine it on his own. One way of determining fixed asset value is to add the asset's construction costs to its capitalized expenses. Drozal knew there was a problem with White Flame's reported capitalized expenses, because Jack White had told him that because the plant was only producing at 20% of capacity, they had included only 20% of their production costs as expenses; the remaining 80% of the production costs were added to the fixed asset value of the plant. Drozal's superior at Arthur Young informed him that only those costs reasonably associated with construction should be added to the plant's value. JA at 1215; 9 Tr. at 236. Drozal's investigation into the treatment of the production costs was limited mainly to talking with Jack White, and reviewing the construction costs and

---

[5] Russell Brown had merged with Arthur Young by this time. *See supra* note 4.

capitalized expenses reported in White Flame's books, which Drozal knew that Kuykendall had prepared. 9 Tr. at 186.[6] Drozal concluded, based primarily on information provided by convicted felons, that the plant's value at the end of 1980 was $4,393,242.66, exactly the same figure Kuykendall had calculated. JA at 1219. Using this figure as a base, Drozal factored in the 1981 construction costs and capitalized expenses, and concluded that White Flame's 1981 fixed asset value was approximately $4.5 million. *Id.*

Once Drozal determined White Flame's fixed asset value, he had to determine how that value should be treated for accounting purposes. This involved examining the circumstances of the Co-op's acquisition of White Flame. If the Co-op had owned White Flame from the beginning of construction in 1979, White Flame's value for accounting purposes would be its fixed asset value, $4.5 million. If the Co-op had purchased White Flame from Jack White, however, then White Flame's value for accounting purposes would be its fair market value at the time of purchase. Moreover, if the Co-op had purchased White Flame from White, the transaction would have to be closely scrutinized, because White was an officer of the Co-op. Drozal concluded that the Co-op had owned White Flame from the beginning, and thus that the plant should be valued at $4.5 million. He based this conclusion on the Co-op's having lent White funds for the

---

[6] Kuykendall testified that he fabricated these numbers on White's direction and attempted to cover up the scheme by slightly varying the percentages of costs expensed. 7 Tr. at 258.

plant's construction and operation; that White was supervising the construction and operation; and that the court decree stated that all of the Co-op's loans to White had been investments in the plant. 9 Tr. at 224. Drozal believed that characterizing White Flame as having always been owned by the Co-op reflected "economic reality." *Id.*

In concluding that the Co-op had always owned White Flame, Drozal ignored a great deal of information suggesting exactly the opposite. For example, although he relied on the court decree's statement that the Co-op's loans to White were really investments, Drozal ignored that part of the decree that stated that the Co-op had acquired White Flame on February 15, 1980. He ignored the facts that White Flame's tax returns indicated that it was owned by Jack White and Edwin Dooley; that each had initially invested $125,000 in White Flame; that White had eventually bought Dooley out; that White had always personally guaranteed the loans he received from the Co-op; and that the Co-op's 1979 audit contained no mention of White Flame. Drozal never talked with Dooley, with any 1979 or 1980 Board members, with the Co-op's lawyer, or with the Co-op's previous auditor.

By concluding that the Co-op had always owned White Flame, Drozal was able to avoid applying auditing standards that required a closer look at the actual acquisition and was also able to avoid having to value the plant at its fair market value. The advantage of reaching this conclusion was clear: Drozal knew that if White Flame were valued at less than $1.5 million, the Co-op's net

worth for 1981 would have been wiped out. 10 Tr. at 41.[7] Drozal also knew that bad news about the Co-op's financial condition could provoke a run on the demand notes and thus deprive the Co-op of its primary source of funds. 9 Tr. at 189.

D. The 1981 Audit Report to the Board

On April 22, 1982, Arthur Young[8] presented its 1981 audit report to the Co-op's Board of Directors. Arthur Young concluded that with two exceptions, the Co-op's consolidated financial statements fairly presented the Co-op's financial position. The relevant exception stated that Arthur Young had "some doubt as to the recoverability of the investment in the gasohol plant of White Flame Fuels, Inc. and its continuing operations." JA at 235. The firm explained: "Management has not prepared projections and other analyses to assess the potential recovery of this investment. Accordingly, we are unable to satisfy ourselves as to the appropriate carrying value of such amounts as presented in the accompanying consolidated financial statements." *Id.*

The financial statements attached to the audit report listed the Co-op's assets at $20,869,300. Included in this

---

[7] One expert witness testified at trial that as of December 31, 1981, White Flame was not economically viable, and that its liquidation value was $500,000 to $700,000. 4 Tr. at 97. Another expert, who used a more sophisticated appraisal method, testified that White Flame's fair market value at the end of 1981 was between $444,000 and $1.5 million. 4 Tr. at 184. Arthur Young did not attempt to rebut this testimony.

[8] *See supra* note 4.

total was $4,522,086 for the gasohol plant. The Co-op's liabilities totaled $18,246,743, including $12,164,007 in unredeemed patron demand notes. The Co-op's net worth was $2,622,557. The financial statement's Note 9 addressed White Flame. The note stated, in relevant part:

> Financing of the initial construction and subsequent revisions which totaled approximately $4,522,000, was provided by the Co-op. Also, from the initial start of production through December 31, 1981, the Co-op has provided operating capital for White Flame. As of December 31, 1981, the Co-op had an investment of approximately $5,830,000 in White Flame. The ability of the Co-op to continue providing funds to cover the operating losses of White Flame Fuels, Inc. (currently averaging $100,000 per month) until such time that improvements in market conditions and production efficiency permit profitable operations are not determinable. The combination of factors as mentioned above, which must result favorably, cast doubt on the recovery by the Co-op of its investment in White Flame Fuels, Inc. and the recovery by White Flame Fuels, Inc. of its investment in plant and equipment on the basis of a going concern. Projections and other analyses have not been prepared by management in order to assess the potential recoverability of this investment.

JA at 251-52.

Arthur Young did not tell the Board that it concluded that the Co-op had always owned White Flame and thus was able to value the plant at $4.5 million. 9 Tr. at 227. Nor did it tell the Board that if the Co-op had purchased

White Flame, as opposed to owning it from the beginning, there might be a net worth problem. Moreover, Arthur Young never specifically asked the Board or the Co-op's management for projections as to the operations of White Flame. 10 Tr. at 57-58.

E. The 1982 Annual Meeting

On May 27, 1982, the Co-op held annual meeting. Approximately 350 people attended. At the meeting, the Co-op distributed condensed financial statements that purported to convey the economic health of the organization.[9] The condensed financial statement for 1981 stated that the Co-op's assets were $20,869,300 and that its liabilities were $18,246,743, leaving the Co-op with a net worth of $2,622,557. JA at 1231. The statement included White Flame's $4.5 million asset value in its total assets, but did not include White Flame's $1.2 million loss. The statement also failed to include any of the information about White Flame's status found in Note 9 of the audit report.

The condensed financial statement also contained the annual meeting's agenda. Listed as giving the financial report was "Harry C. Erwin, C.P.A., ARTHUR YOUNG & COMPANY." JA at 1241. Also present from Arthur Young was Joe Cabaniss. Erwin received the two condensed

[9] The Co-op prepared these statements based on Arthur Young's audit report and the accompanying financial statement.

financial statements when he arrived at the meeting. He had no advance preparation as to the statement's contents. As he began his presentation, Erwin informed the members that they had condensed statements and that copies of the full audit were at the Co-op's offices. Erwin then started to discuss the condensed statement. The audience soon began asking questions about the acquisition of White Flame and its financial status. When asked how much money White Flame had lost, Erwin responded that it was a separate corporation under federal law. Erwin was also asked how the Co-op had acquired White Flame and responded that he thought the Board had voted to acquire it. During these interchanges, White Flame's $1.2 million loss was disclosed to the audience. The meeting began to get very heated, with the audience asking many questions about White Flame and other items in the condensed statement. As the questions increased in both frequency and intensity, Erwin was unable to respond and the Board moved the meeting on.

The result of Erwin's five-minute presentation was that the audience knew that the Co-op owned White Flame and that the plant had $1.2 million in losses. However, Erwin did not disclose the following: Arthur Young's conclusion that the Co-op had always owned White Flame; that as a result of this conclusion White Flame was valued at $4.5 million; the material in Note 9 of the full financial statement; that Arthur Young had qualified its audit opinion; that Arthur Young could not satisfy itself as to the proper carrying value of White Flame; or that a write-down of White Flame to its fair market value would wipe out the Co-op's net worth. 12 Tr. at 112-13.

F. The 1982 Audit

The Co-op also hired Arthur Young to perform the 1982 audit. Erwin and Drozal were again Arthur Young's point men. Joe Cabaniss was again selected to work with Drozal and prepared a background memo on the 1982 audit. JA at 1234. The memo classified the Co-op as a "close monitoring client," i.e., a client that might pose some type of risk to Arthur Young. The memo also addressed issues of particular importance for the Co-op's audit. These included the recoverability of the gasohol plant and the condensed financial statements for 1981. As regards the gasohol plant, Cabaniss, before talking to Drozal, believed its acquisition involved a related party transaction, and hence that the Co-op had not always owned it. Cabaniss also expressed his doubts as to whether the gasohol plant could ever make money. As regards the condensed financial statements, Cabaniss noted:

> At the annual meeting the patrons are provided with condensed financial statements. Last year they were given a consolidated balance sheet and a Co-op only income statement which did not reflect the equity in the earnings (loss) of White Flame. We should advise the client of this misleading presentation and find an acceptable manner of presentation.

JA at 1240.

Arthur Young proceeded with the audit. Standard auditing procedures require the auditor to obtain a client representation letter. This letter, drafted by the auditor, but signed by the client's chief executive and financial

officers, states that the client's financial records are accurate and consistent with generally accepted accounting principles. The Co-op's letter for the 1982 audit was signed by Fred Howard, who had replaced Jack White as the Co-op's General Manager. Kirit Goradia, the Co-op's office manager, who essentially functioned as its chief financial officer, did not sign the letter. In the space provided for signing one's name, Goradia wrote: "My only response is attached herewith not as part of this letter." JA at 1245. The attachment stated: "This is to state that during the course of your 1982 audit of books and records of [the Co-op and White Flame], I have not intentionally withheld any information from you." JA at 1246. Goradia told Cabaniss that he did not want to sign the letter because if something happened later, he did not want to be accused of wrongdoing. 11 Tr. at 140. Normally, when a company's chief financial officer refuses to sign a representation letter, the auditor is supposed to disclaim the audit opinion or issue an adverse opinion. Id. at 142. Arthur Young, however, did not believe that Goradia had refused to sign the letter, and thus did neither.[10]

G. The 1982 Audit Report to the Board

Arthur Young presented its 1982 audit report to the Board on March 7, 1983. The 1982 report was substantially similar to the 1981 report. Arthur Young again

---

[10] Arthur Young did not get a signed client representation letter for the 1981 Co-op audit either. When asked about this at trial, Cabaniss responded: "Now, the year before, we thought we had that sucker, and . . . we believed we had it. There was no reason to even think it had been refused." 11 Tr. at 142.

stated that "there is some doubt as to the recovery of the investment in [White Flame] and its continuing operation. Management has not prepared projections and other analyses to assess the potential recovery of this investment." JA at 258. Arthur Young again concluded: "Accordingly, we are unable to satisfy ourselves as to the appropriate carrying value of such amounts as presented in the accompanying consolidated financial statement." *Id.* Arthur Young's concerns were more fully explained in Note 8 to the financial statement, which was basically the same as the 1981 audit report's Note 9.

The 1982 financial statement reported that the Co-op had assets of $17,127,986 and liabilities of $15,741,240, resulting in a net worth of $1,386,746. The gasohol plant was listed as an asset worth $4,537,520.

H. The 1983 Annual Meeting

The Co-op's 1983 annual meeting was held on March 24 of that year. Sometime before the meeting Goradia and Cabaniss discussed the Co-op's condensed financial statements. Cabaniss told him that Arthur Young's name should not be on the condensed statement because the statement would be misleading without the explanatory notes. Shortly before the meeting Cabaniss and Drozal received a copy of the condensed statement, which stated in boldface letters across the top of the page: "The following financial information was condensed from Arthur Young & Company's Annual Audit." JA at 1248. Drozal and Cabaniss saw that Arthur Young's name was on the statement and that Note 8 was omitted, but said nothing to Goradia. 11 Tr. at 149.

The annual meeting's program stated that the financial report would be given by Arthur Young. Cabaniss began the financial report by informing the audience that they possessed condensed statements, and that full audit reports were at the Co-op's offices. He knew as he began that the condensed statement was misleading because it did not contain the explanatory notes to the audit. Id. at 150. The presentation lasted three minutes. Cabaniss did not tell the audience that the report was misleading. He did not tell them about Note 8, that Arthur Young was unable to satisfy itself as to White Flame's value, or that if White Flame was written down to its fair market value the Co-op might be in financial trouble. At that time, White Flame's stated value after depreciation was approximately $3.5 million. The Co-op's net worth was $1.3 million. If the plant had been written down to less than $2.2 million, the Co-op's net worth would have been wiped out.[11]

I. Bankruptcy

The demand note program was not the Co-op's only source of funds. It also received loans and lines of credit from the Cooperative Finance Association (CFA), which was owned by Farmland, a regional supply cooperative. William Moon, a vice-president of CFA, had informed the Co-op that because of its reliance on demand notes, if the amount of invested notes dropped below $9.5 million, CFA would cut off the Co-op's line of credit. In the fall of

---

[11] *See supra* note 5 for the experts, appraisals of White Flame's value.

1983, CFA advanced the Co-op a $5.78 million line of credit to finance its grain inventory and operations. 3 Tr. at 46. In February of 1984, representatives of the Co-op met with CFA to arrange more financing. 12 Tr. at 12. Later that month the Co-op had a slight run on the demand notes. Id. The Co-op asked CFA for the money on its line of credit to protect itself from further runs. *Id.* CFA, because total demand note investments had dropped below $9.5 million, decided not to advance the Co-op any of the $800,000 the Co-op had remaining on its line of credit. 3 Tr. at 161. The Co-op then filed bankruptcy proceedings on February 23, 1984, to protect itself from a run on the demand notes. 12 Tr. at 13. In the subsequent bankruptcy disclosure statement, which the bankruptcy court approved on September 4, 1984, the Co-op asserted that three factors caused its bankruptcy: (1) ineffective management; (2) using demand notes as the primary source of financing; and (3) the financial problems of White Flame. AY Ex. 223. The result of the bankruptcy filing was that the demand notes were frozen in the bankruptcy estate, and thus were no longer redeemable at will by the noteholders.

J. Trial

After the Co-op filed for bankruptcy, it remained as debtor in possession until October of that year, when the bankruptcy court appointed Thomas Robertson as trustee. On February 14, 1985, Robertson, on behalf of the Co-op and certain demand noteholders, filed suit against forty individuals and entities, including members of the Co-op's Board, the Co-op's lawyers, Jack White, Kirit

Goradia, Gene Kuykendall, and Arthur Young. On September 27, 1985, the district court certified a class of noteholders consisting of people who purchased demand notes between February 15, 1980, and February 23, 1984, naming Bob Reves, Frances Graham, and Robert Gibbs the class representatives.[12] Robertson thus no longer represented the Class, but only the Co-op. Before trial, Robertson and the Class settled with all defendants except Arthur Young and Jack White's legal representatives.[13]

Robertson and the Class asserted seven claims against Arthur Young. Four of these claims are relevant to this appeal: (1) Robertson's claim that Arthur Young breached its auditing contract with the Co-op because the firm did not perform its audits in accordance with generally accepted accounting principles and auditing standards; (2) the Class' claim that Arthur Young induced the purchase of demand notes through the concealment of the Co-op's financial position in violation of 15 U.S.C. § 78j(b) and 17 C.F.R. § 240.10b-5; (3) the Class' claim that Arthur Young induced the purchase of demand notes though the concealment of the Co-op's financial position in violation of Arkansas securities law; and (4) Robertson's and the Class' claim that Arthur Young was a material participant in the operation and management of the Co-op, in violation of the Racketeer Influenced and Corrupt Organizations Act (RICO), 18 U.S.C.

---

[12] Future references to the noteholders will be to the "Class."

[13] Subsequent to trial, Robertson and the Class settled with White's lawyers as well.

§§ 1961-1968. Arthur Young then cross-claimed against the Co-op's Board of Directors, seeking contribution.

Before trial, the district court dismissed Robertson's action for securities fraud and Robertson's and the Class' breach of contract claim. *See Robertson v. White (Robertson I)*, 633 F. Supp. 954, 974, 976 (W.D. Ark. 1986). The district court also determined before trial that the demand notes were securities under both federal and Arkansas law. *See Robertson v. White (Robertson II)*, 635 F. Supp. 851, 865 (W.D. Ark. 1986). Arthur Young then moved for summary judgment on Robertson's and the Class' RICO claim, which the district court granted. *See Robertson v. White (Robertson III)*, Nos. 85-2044, 85-2096, 85-2155, 85-2259, slip op. at 116 (W.D. Ark. Oct. 15, 1986).

Trial commenced on October 22, 1986, and lasted approximately a month. Robertson's and the Class' witnesses consisted mainly of Board members, accounting, legal, and appraisal experts, and Arthur Young personnel. Arthur Young's witnesses consisted mainly of Board members, a legal expert, and two state court clerks.[14]

---

[14] While reviewing the trial transcript after oral argument, we noticed that Board member Larry Heatherington, who was not listed in the transcript's table of contents, did testify. *See* 2 Tr. at 201-40. We also noticed that at least one part of the trial was not transcribed, namely, the closing argument of counsel for Jack White's law firm. *See* 16 Tr. at 130-33. Because of our concern with the integrity of the transcript, we requested counsel for Arthur Young and the Class to provide us with a list of the witnesses who testified. Robertson's list, which Arthur Young agreed was accurate, does not include Heatherington. We can only conclude that both parties relied on the transcript's various tables of contents. As a result, we still have

(Continued on following page)

After trial, the jury found that Arthur Young had committed both state and federal securities fraud.[15] The jury found that the Class' damages as a result of the fraud totaled $6,121,652.94.

After the jury returned its verdict, the district court asked the parties to make all motions that might affect the judgment. Responding to these motions in a post-trial memorandum, the district court decided that sums the Class had already received as a result of settlements should offset the jury's verdict. *See Robertson v. White (Robertson IV)*, Nos. 85-2044, 85-2096, 85-2155, 85-2259, slip op. at 37 (W.D. Ark. Feb. 5, 1987). The district court also denied Arthur Young's motions for judgment notwithstanding the verdict (JNOV) on the state and federal securities claims. *Id.* at 49, 61. Finally, the district court rejected Arthur Young's argument that the court wrongly denied the firm's contribution claim. *Id.* at 54.

The district court's final judgment as regards Arthur Young was as follows:

> Arthur Young is ordered to pay to the Class $6,121,652.94, plus prejudgment interest, attorney fees (only on the state securities claim) and

---

(Continued from previous page)

reservations about the trial transcript's accuracy. Because apparently neither of the parties share our reservations, we will treat it as accurate.

[15] Although not relevant to the issues on appeal, we note that the jury also found that Arthur Young negligently performed the Co-op's 1981 and 1982 audits, that the Co-op was contributorily negligent, and that Arthur Young had not committed common-law fraud in its performance of those audits.

> costs, under both state and federal claims, subject to a credit in the amount of $5,774,780, conditional on settlements with the Class being approved. The judgment shall bear prejudgment interest and carry an award of fees under the state act, and prejudgment interest under the federal securities law claims. Questions relating to the eligibility for fees under the federal claim, and the amount of any fees, shall be later determined. The court shall set a schedule for plaintiffs to file a bill of costs and a petition to establish the amount of prejudgment interest and fees due. The Class shall be allowed the larger net recovery under this Count, after allowing credits and determining fees, interest and costs.

Amended Judgment Order, Nos. 85-2044, 85-2096, 85-2155, 85-2259 (W.D. Ark. Apr. 23, 1987). Arthur Young, the Class, and Robertson appealed the various judgments, rulings and orders.

K. Subsequent History

This case first came before us in 1988. *See Arthur Young & Co. v. Reves*, 856 F.2d 52 (8th Cir. 1988). At that time we reversed the district court's judgment on the threshold issue of whether the demand notes were securities under federal or Arkansas law, holding that they were not. *See id.* at 55. Subsequently, the Supreme Court vacated our opinion and reversed, holding that the notes were securities within the meaning of § 3(a)(10) of the Securities Act of 1934, codified at 15 U.S.C. § 78c(a)(10) (1988). *See Reves v. Ernst & Young*, 110 S. Ct. 945, 953

(1990). On remand, we now address the plethora of issues the parties originally raised on appeal.

II.

A. Class Certification

Arthur Young argues as a threshold matter that the district court erred in certifying the Class. "A district court has broad discretion in determining whether to certify a class, and its determination will not be overturned absent a showing that it abused its discretion." *Gilbert v. City of Little Rock,* 722 F.2d 1390, 1399 (8th Cir. 1983), *cert. denied,* 466 U.S. 972 (1984). The Class in this case consisted of all persons who had claims against Arthur Young, as well as the other defendants, "arising out of or based upon the . . . demand notes." Sept. 27, 1985 Certification Order, JA at 1736. Although the record is far from clear on this point, it appears that the Class was made up of 1,685 people who bought demand notes from February 1980 until the Co-op's bankruptcy in February 1984.[16] The district court decided to certify the Class after reviewing de novo the United States magistrate judge's proposed findings and recommendations. The magistrate judge had concluded, after reviewing ample evidence and considering the relevant factors, that the proposed class of noteholders unquestionably satisfied the requirements of Fed. R. Civ. P. 23. On the record before us, we find no abuse of discretion.

---

[16] For the purposes of the federal and state securities fraud claims, the Class consisted of all those who purchased notes after Arthur Young's first audit report to the Board on April 22, 1982.

B. Robertson's Breach of Contract Claim

Robertson argues that the district court erred in dismissing his breach of contract of claim against Arthur Young. In Count V of the complaint, Robertson alleged that Arthur Young breached its agreements with the Co-op to conduct the 1981 and 1982 audits in accordance with generally accepted accounting principles and auditing standards. Robertson asked that Arthur Young be held liable for all damages it caused and that it return the fees the Co-op had paid it for services rendered. The district court dismissed Robertson's claim on the ground that the claim alleged misfeasance, i.e., that Arthur Young performed the Co-op's audits in a deficient manner, and that under Arkansas law, misfeasance is a tort, and not a contract, claim. *See Oliver v. Bluegrass Resources Corp.*, 678 S.W.2d 769, 770 (Ark. 1984); *McClellan v. Brown*, 632 S.W.2d 406, 407 (Ark. 1982); *Morrow v. First Nat'l Bank*, 550 S.W.2d 429, 431 (Ark. 1977). We also note that under Arkansas law, the trial court may determine whether an action sounds in tort or contract. *See L.L. Cole & Son, Inc. v. Hickman*, 665 S.W.2d 278, 281 (Ark. 1984).

Robertson concedes in his brief that his breach of contract claim is based on Arthur Young's misfeasance. He contends, however, that Arkansas' distinction between tort-based misfeasance claims and contract-based nonfeasance claims was not intended to prevent a party with a misfeasance claim from bringing a breach of contract cause of action. Robertson, however, adduces no support for this contention. It is clear that Robertson raises this issue on appeal because although the jury found that Arthur Young negligently performed the audits, it also found that the Co-op was contributorily

negligent, a defense which Robertson admits is fatal to his negligence claim. Robertson and Class Brief at 64.

Because under Arkansas law Robertson's breach of contract claim actually sounds in tort, we conclude that the district court properly dismissed it.

C. The RICO Claim

The Class argues that the district court improperly granted summary judgment in favor of Arthur Young on its RICO claim. The Class alleged in its complaint that Erwin, Drozal, and Cabaniss conducted or participated in the affairs of the Co-op, committing both mail fraud and securities fraud, in violation of 18 U.S.C. § 1962(c), which provides: "It shall be unlawful for any person employed by or associated with any enterprise engaged in, or the activities of which affect, interstate or foreign commerce, to conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs through a pattern of racketeering activity. . . . "

Summary judgment is proper where, viewing the evidence in the light most favorable to the nonmoving party, and giving that party the benefit of all reasonable inferences to be drawn from that evidence, the movant is entitled to judgment as a matter of law. *See Agristor Leasing v. Farrow*, 826 F.2d 732, 734 (8th Cir. 1987). Viewing the evidence in the light most favorable to the Class, we agree with the district court that, as a matter of law, Arthur Young's involvement with the Co-op did not rise to the level required for a RICO violation. In *Bennett v. Berg*, 710 F.2d 1361 (8th Cir.) (en banc), *cert. denied*, 464

U.S. 1008 (1983), we addressed the nature of the participation required of a RICO defendant before liability is appropriate: "A defendant's participation must be in the conduct of the affairs of a RICO enterprise, which ordinarily will require some participation in the operation or management of the enterprise itself." *Id.* at 1364. Arthur Young's involvement with the Co-op was limited to the audits, meetings with the Board of Directors to explain the audits, and presentations at the annual meetings. In the course of this involvement it is clear that Arthur Young committed a number of reprehensible acts, but these acts in no way rise to the level of participation in the management or operation of the Co-op.

The Class contends that we should follow the Eleventh Circuit's decision in *Bank of Am. Nat'l Trust & Sav. Ass'n v. Touche Ross & Co.*, 782 F.2d 966 (11th Cir. 1986), where that court stated that it "is not necessary that a RICO defendant participate in the management or operation of the enterprise." *Id.* at 970. We are aware of the inconsistencies between the circuits regarding the necessary level of participation for RICO liability. *See Yellow Bus Lines v. Drivers, Chauffeurs & Helpers Local Union 639*, 913 F.2d 948, 952-55 (D.C. Cir. 1990) (en banc) (reviewing the varied approaches to the participation requirement taken by the Second, Fourth, Fifth, Seventh, Eighth and Eleventh Circuits and adopting the Eighth Circuit's standard), *cert. denied*, No. 90-872 (U.S. June 17, 1991). But until the Supreme Court rejects our standard or this court en banc overrules *Bennett*, we are bound to follow that decision. Therefore, we conclude that the district court properly granted summary judgment in favor of Arthur Young on the Class' RICO claim.

D. Demand Notes and Arkansas Law

Arthur Young next argues that the district court erred in holding that the Co-op's demand notes were securities under Arkansas law. We review de novo the district court's ruling on this state law issue. *See Salve Regina College v. Russell,* 111 S. Ct. 1217, 1221 (1991). The district court based its conclusion on three considerations: the legislative history of Arkansas' securities laws; Arkansas' broad, protectionist approach to securities regulation; and federal case law. *See Robertson II,* 635 F. Supp. at 855-65. As regards the third consideration, another Arkansas federal court has observed that "[t]he Arkansas definition of a security is essentially identical to the definition under federal securities laws." *See First Fin. Fed. Sav. & Loan Ass'n v. E.F. Hutton Mortgage Corp.,* 652 F. Supp. 471, 475 (W.D. Ark.), *aff'd,* 834 F.2d 685 (8th Cir. 1987). We have carefully considered the district court's comprehensive legal analysis of this issue, and conclude, based on this analysis and the Supreme Court's decision that the demand notes are securities under federal law, that the demand notes are also securities under Arkansas law.

E. The State Securities Fraud Claim

Arthur Young next argues that the district court erred in denying its motion for JNOV on the state securities fraud claims. In reviewing a district court's denial of a motion for JNOV, we

> must consider the evidence in the light most favorable to the prevailing party, assume that the jury resolved all conflicts of evidence in

> favor of that party, assume as true all facts which the prevailing party's evidence tended to prove, [and] give the prevailing party the benefit of all favorable inferences which may reasonably be drawn from the facts.

Atlas Pile Driving Co. v. DiCon Fin. Co., 886 F.2d 986, 989 (8th Cir. 1989). We will affirm the denial, "if in light of the foregoing, reasonable jurors could differ as to the conclusion that could be drawn from the evidence." *Id.*

Arthur Young argues that even accepting all of the Class' allegations as true, it cannot be held liable for securities fraud under Arkansas law. Under Arkansas law, civil liability for securities fraud exists for any person who

> [o]ffers or sells a security by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of circumstances under which they are made, not misleading, the buyer not knowing of the untruth or omission, and who does not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of the untruth or omission.

Ark. Stat. Ann. § 23-42-106(a)(l) (B) (1987).[17] Arthur Young contends that it cannot be held liable under

---

[17] At the time of trial, this section was codified as Ark. Stat. Ann. § 67-1256(a)(2) (1980 Replacement). Section 67-1256 was modeled after § 410 of the Uniform Securities Act. Section 410(a)(1)(2) of the Uniform Act in turn was modeled after § 12(2) of the Securities Act of 1933, codified at 15 U.S.C. § 771(2) (1988).

§ 106(a) because it was neither an offerer or seller of securities. The Class does not contest this point, arguing that Arthur Young was not charged with primary liability under § 106(a), but with secondary liability under Ark. Stat. Ann. § 23-42-106(c), which provides:

> Every person who controls a seller liable under subsection (a) of this section . . . ; every partner, officer, or director of such a seller or purchaser; every person occupying a similar status or performing a similar function; every employee of such a seller or, purchaser who materially aids in the sale; and every broker-dealer or agent who materially aids in the sale are [sic] also liable jointly and severally with, and to the same extent as, the seller or purchaser, unless the nonseller or nonpurchaser who is so liable sustains the burden of proof that he did not know and in the exercise of reasonable care could not have known, of the existence of the facts by reason of which the liability is alleged to exist.[18]

Section 106(c) expressly creates two types of secondary liability for securities fraud, control person liability and aiding and abetting liability. *See, e.g., Hogg v. Jerry*, 773 S.W.2d 84, 87 (Ark. 1989). In denying Arthur Young's motion for JNOV, the district court reasoned that because Arthur Young "originated" the material statements that were used to sell the demand notes, "it obviously had the power to 'control' the content of those statements." *Robertson IV*, slip op. at 47. Arthur Young contends that the proper test for control person liability is whether the

---

[18] At the time of trial, this section was codified as Ark. Stat. Ann. § 67-1256(b) (1980 Replacement).

defendant "actually participated in (*i.e., exercised* control over) the operations of the corporation in general," and if so, whether the defendant "possessed the power to control the specific transaction or activity upon which the primary violation is predicated." *See Metge v. Baehler*, 762 F.2d 621, 631 (8th Cir. 1985) (emphasis in original), *cert. denied sub nom. Bankers Trust Co. v. Metge*, 474 U.S. 1072 (1986). We note in passing that Arthur Young certainly did not direct the Co-op's operations. We need not determine, however, whether the test for control person liability under 15 U.S.C. § 77o (1988) we established in *Metge* also applies to the Arkansas securities laws. Rather, we believe that the other type of secondary liability for securities violations, aiding and abetting liability, applies to the facts of this case.

Section 106(c) explicitly makes liable for securities fraud any employee of the seller who materially aids in the sale of the security. As the Alabama Supreme Court has observed concerning its version of the same statute:

> A third category under the Alabama Act that goes beyond the comparable federal provision enumerates persons who cannot properly be considered control persons, such as employees of the seller or broker-dealers or agents who may have participated in the sale. The latter persons are included on the basis of what may be considered an express statutory aiding and abetting theory, since the employee, broker-dealer or agent must have "materially aid[ed] in the sale." Therefore, to hold a person liable a plaintiff need not show any active connivance or participation by the alleged control person, except in the case of an employee, broker-dealer,

> or agent; all he need do is establish the defendant's status, either as a controlling person, a partner, or an occupant of some other statutory classification . . . plus the fact of the seller's liability. The defendant then is left with only one defense. . . . He may show that he did not know, and in the exercise of reasonable care could not have known, of the existence of the facts by reason of which the seller's liability is alleged to exist.

Foster v. Jesup & Lamont Sec. Co., 482 So. 2d 1201, 1207 (Ala. 1986) (quoting Rediker, *Alabama's "Blue Sky Law" – Its Dubious History and Its Current Renaissance*, 23 Ala. L. Rev. 667, 714 (1971)).[19]

The district court, in denying Arthur Young's motion for JNOV on this issue, did not discuss § 106(c), but instead relied on an amalgam of rather tenuous theories.

---

[19] The Alabama statute provides:

> Every person who directly or indirectly controls a seller liable under subsection (a) of this section, every partner, officer or director of such a seller, every person occupying a similar status or performing similar functions, every employee of such a seller who materially aids in the sale and every broker-dealer or agent who materially aids in the sale are [sic] also liable jointly and severally with and to the same extent as the seller, unless the nonseller who is so liable sustains the burden of proof that he did not know and in the exercise of reasonable care could not have known, of the existence of the facts by reason of which the liability is alleged to exist.

Ala. Code § 8-6-19(b) (1984), *quoted in Foster*, 482 So. 2d at 1208 n.22. Section 8-6-19(b), like the Arkansas statute, is based on § 410 of the Uniform Securities Act. *See id.* at 1207.

See Robertson IV, slip op. at 40-48. Nonetheless, we believe the district court's instruction to the jury on the state securities claim fulfilled the requirements of § 106(c). The district court instructed the jury that to hold Arthur Young liable for violating Arkansas' blue sky law, it had to find: (1) that the Co-op sold demand notes to the Class by means of untrue statements or omissions of material facts; (2) that the Class did not know of the untrue statements or the omissions;[20] (3) that the untrue statements or the omissions "originated" with Arthur Young; (4) that Arthur Young knew that the statements were being communicated to the Class, and that they were material, "being of the kind and nature that a reasonable person would foreseeably rely on them;" and (5) that Arthur Young knew the statements were false when it made them. 18 Tr. at 79-80. Thus, the jury could only hold Arthur Young liable if it concluded that Arthur Young originated the untrue statements or omissions, knew that the statements were communicated to the Class, and knew that the Class would rely on them to purchase the demand notes; in other words, that Arthur Young "materially aided" in the sale of the demand notes. We note that the trial evidence provides ample support for the jury's verdict against Arthur Young on this issue.

Because we believe this instruction generally comports with the requirements of § 106(c), the only issue

---

[20] Arthur Young also contends that the Class did not satisfy its burden of proof that it did not know of the omissions. That, however, is the theory behind the Class' securities claim in general. We believe that on the facts of this case, a sufficient showing was made.

that remains is whether the district court's failure to instruct the jury that Arthur Young was not liable if it did not know, and in the exercise of reasonable care could not have known, of the existence of the facts by reason of which the Co-op's liability was alleged to exist, constitutes a ground for reversal. *See* Ark. Stat. Ann. § 23-42-106(c). We think not. The district court instructed the jury not to hold Arthur Young liable unless the firm "originated" the linchpin of the securities fraud. By establishing such a high threshold for liability, the district court, perhaps unintentionally, made sure that the jury would not hold Arthur Young liable if it did not know of the facts giving rise to the fraud. Therefore, that no specific instruction was given on this defense does not constitute a ground for reversal because the instruction that was given achieved the same result.

In sum, we believe that Arkansas law does provide for secondary liability for securities fraud in this case. The district court's instructions on this issue, while not precisely comporting with the requirements of § 23-42-106(c), did generally meet those requirements. As a result, the jury could have held Arthur Young liable only if it concluded that the firm materially aided in the sale of the demand notes. Thus, we conclude that the district court properly denied Arthur Young's motion for JNOV on this issue.

F. The Rule 10b-5 Claim

1. Background

Arthur Young next argues that the district court erred in denying its motion for JNOV on the federal securities

claim because it was entitled to judgment as a matter of law. Rule 10b-5[21] provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce . . .
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

---

[21] Rule 10b-5 implements 15 U.S.C. § 78j (1988), which states in pertinent part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe. . . .

The Supreme Court has referred to § 10b as a " 'catchall' clause to enable the Commission 'to deal with new manipulative [or cunning] devices.' " See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 203 (1976) (bracketed material in original).

17 C.F.R. § 240.10b-5 (1990). The purpose behind Rule 10b-5 is to "transcend the gaps and limits of the common law actions available to securities traders injured by false representations or failures to disclose." R. Clark, Corporate law 310 (1986). The rule has been referred to as "a judicial oak which has grown from little more than a legislative acorn," *see Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975) (Rehnquist, J.), and as "a horse of dubious pedigree but very fleet of foot." *See* L. Loss, Fundamentals of Securities Regulation 820 (1983). Our review of the case law has brought home the accuracy of these characterizations.

The essential components of a Rule 10b-5 claim are scienter, causation, and damages. *See Abbey v. Control Data Corp. (In re Control Data Sec. Litig.)*, No. 90-5107, slip op. at 4 (8th Cir. May 10, 1991). Primarily at issue in this case is causation, which has two elements. To satisfy the first element, a plaintiff must prove that the allegedly fraudulent acts caused the plaintiff to purchase the securities. *See Harris v. Union Elec. Co.*, 787 F.2d 355, 366 (8th Cir.), *cert. denied*, 479 U.S. 823 (1986). We have variously characterized this showing as a type of "causation in fact," *see Continental Grain (Austl.) Pty. Ltd. v. Pacific Oilseeds, Inc.*, 592 F.2d 409 (8th Cir. 1979), "but for causation," *see Harris*, 787 F.2d at 366, "reliance," *see Austin v. Loftsgaarden*, 675 F.2d 168, 177 (8th Cir. 1982), or as satisfying Rule 10b-5's "in connection with the purchase or sale of any security" requirement. *See Forkin v. Rooney Pace, Inc.*, 804 F.2d 1047, 1049 (8th Cir. 1986).[22] In the

---

[22] Indeed, the district court instructed the jury in this case: "The 'in connection with' aspect of this element is satisfied if

(Continued on following page)

lingua franca of Rule 10b-5 cases, however, this showing is usually referred to as "transaction causation." *See. e.g., Wilson v. Ruffa & Hanover, P.C.*, 844 F.2d 81, 86 (2d Cir. 1988); *LHLC Corp. v. Cluett, Peabody & Co.*, 842 F.2d 928, 931 (7th Cir.), *cert. denied*, 488 U.S. 926 (1988); *Zoelsch v. Arthur Andersen & Co.*, 824 F.2d 27, 35 n.5 (D.C. Cir. 1987); *see also* Merritt, *A Consistent Model of Loss Causation in Securities Fraud Litigation: Suiting the Right to Fit the Wrong*, 66 Tex. L. Rev. 469, 471-72 (1988) (discussing transaction causation). Thus, for consistency's and simplicity's sake, we will refer to this showing as "transaction causation."

To satisfy the second causation element the plaintiff must prove that the allegedly fraudulent acts caused the plaintiff's economic harm. *See Austin*, 675 F.2d at 178. As with transaction causation, we have characterized this showing as a type of "causation in fact," *see Vervaecke v. Chiles, Heider & Co.*, 578 F.2d 713, 719 (8th Cir. 1978); *St. Louis Union Trust Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 562 F.2d 1040, 1049 (8th Cir. 1977), *cert. denied*, 435 U.S. 925 (1978), although the two showings are analytically distinct. Again, endeavoring to maintain some consistency with our sister circuits, *see, e.g., Bastian v. Petren Resources Corp.*, 892 F.2d 680, 683-84 (7th Cir.), *cert. denied*, 110 S. Ct. 2590 (1990); *Wilson*, 844 F.2d at 85; *Elias v. Arthur Andersen & Co. (In re Financial Corp. of Am. Shareholder Litig.)*, 796 F.2d 1126, 1130 (9th Cir. 1986), and

---

(Continued from previous page)

you find that there was some substantial nexus or relation between the allegedly fraudulent conduct and the sale or purchase of securities." 18 Tr. at 73.

the commentators, *see, e.g.*, Merritt, 66 Tex. L. Rev. 469 *passim*, we refer to this showing as "loss causation."

2. Transaction causation

With regard to causation, Arthur Young first argues that it is entitled to judgment as a matter of law because no one from the Class testified that they heard Arthur Young's presentation at the Co-op's annual meetings and thereafter bought demand notes. Because the Class' claim was based on Arthur Young's misrepresentations at the annual meetings, the firm contends, the Class had to prove that it relied on those misrepresentations in buying the demand notes. *See Vervaecke*, 578 F.2d at 717. The Class' failure to offer evidence of transaction causation, Arthur Young concludes, is fatal to its Rule 10b-5 claim.

The Class responds that because its claim is based primarily on Arthur Young's nondisclosure of material information about the Co-op's financial health, it is entitled to a rebuttable presumption of transaction causation. In making this argument, the Class relies on a long line of cases in which this court has stated that where the defendant's alleged conduct involves primarily a failure to disclose, the plaintiff need not prove transaction causation; instead, such causation will be inferred if the withheld information was material. *See Barnes v. Resource Royalties, Inc.*, 795 F.2d 1359, 1367 (8th Cir. 1986), *cert. denied sub nom. McPherson v. Barnes*, 110 S. Ct. 1129 (1990); *Harris*, 787 F.2d at 366; *Austin*, 675 F.2d at 177; *St. Louis Union Trust Co.*, 562 F.2d at 1048-49. The inference is not conclusive; rather, it creates a rebuttable presumption of transaction causation. *See. e.g., Barnes*, 795 F.2d at 1367.

a. Nature of the Class' Claim

The sub-issue thus becomes whether the Class' Rule 10b-5 claim is based on misrepresentation or nondisclosure. The district court concluded that the Class' claim was based on a nondisclosure theory and instructed the jury accordingly.[23] This is a conclusion of law that we review de novo. *See Vervaecke*, 578 F.2d at 718 n.2. Of great relevance in determining this issue is how a claimant pleads its Rule 10b-5 claim: "While [plaintiff] tries to present this case to us as a case involving primarily nondisclosure, we have carefully examined the pleadings and do not view it as such." *See id.* at 717. In this case, the Class' complaint states its nondisclosure theory: "Defendants . . . are liable because the accountants knew that they were inducing or causing the purchase of demand notes through *concealment* of the Co-op's financial condition." JA at 51 (emphasis added). We recognize that there is some analytical difficulty in separating misrepresentations from nondisclosures, because misrepresentations often result from the withholding of some material fact. On the facts and the pleadings in this case, however, we

---

[23] The district court instructed the jury:

> The second element which the Class must prove by a preponderance of the evidence is that the Class justifiably relied upon the defendant's statements or conduct. However, in order to satisfy this element, the Class need not prove that the Class actually relied on defendant's conduct. Rather, plaintiff's [sic] can satisfy his burden if he proves that the defendant sought to be charged omitted to state a fact to him, and that the omitted fact was material.

18 Tr. at 74-75.

believe that the district court properly characterized this claim as one involving primarily nondisclosure.

Because the Class' claim was premised on a theory of nondisclosure, the Class was entitled to a rebuttable presumption that transaction causation had been shown. Although Arthur Young had notice in the early stages of this action that the Class was going to use the nondisclosure-based rebuttable presumption, *see* Proposed Report and Recommendation on Class Certification, JA at 1454 ("Reliance is unlikely to be an issue in a nondisclosure case. . . . "), it did not attempt to rebut the presumption. For Arthur Young to argue now that it was entitled to judgment as a matter of law because the Class did not show transaction causation is a bold move indeed.[24]

b. Duty to Disclose

Arthur Young raises a second sub-issue with regard to transaction causation, namely, that it could only be held liable for nondisclosure if it had a duty to disclose, and that because it had no such duty, it was entitled to judgment as a matter of law. In making this argument, Arthur Young relies on *Chiarella v. United States*, 445 U.S. 222 (1980), where the Supreme Court stated that nondisclosure is actionable under Rule 10b-5, but that "such liability is premised upon a duty to disclose arising from

---

[24] We note that the district court failed to instruct the jury that the presumption of transaction causation (reliance) was rebuttable. However, Arthur Young has not raised this as a ground for reversal, which is understandable in light of its failure even to attempt to rebut the presumption.

a relationship of trust and confidence." *Id.* at 230.[25] Arthur Young argues that because there is no evidence that it had contacts with the Class, it had no relationship with the Class, and that it thus was under no duty to disclose.

A relationship for purposes of Rule 10b-5 liability, however, requires neither a "physical presence nor face to face conversation." *See SEC v. Washington County Util. Dist.*, 676 F.2d 218, 223 (6th Cir. 1982) (footnote omitted). Rather, whether a relationship exists that gives rise to a duty to disclose depends on the circumstances of the individual case. *See Roberts v. Peat, Marwick, Mitchell & Co.*, 857 F.2d 646, 653 (9th Cir. 1988) (per curiam), *cert. denied*, 110 S. Ct. 561 (1989); *Jett v. Sunderman*, 840 F.2d 1487, 1493 (9th Cir. 1988); *Windon Third Oil & Gas Drilling Partnership v. Federal Deposit Ins. Corp.*, 805 F.2d 342, 347 (10th Cir. 1986), *cert. denied*, 480 U.S. 947 (1987); *Rudolph v. Arthur Andersen & Co.*, 800 F.2d 1040, 1043 (11th Cir. 1986), *cert. denied*, 480 U.S. 946 (1987); *First Va. Bankshares v. Benson*, 559 F.2d 1307, 1314 (5th Cir. 1977), *cert. denied sub nom. Walter E. Heller & Co. v. First Va. Bankshares*, 435 U.S. 952 (1978). The Fifth, Ninth, and Eleventh Circuits

---

[25] Before *Chiarella*, this court had stated that the duty to disclose came from Rule 10b-5 itself. *See Myzel v. Fields*, 386 F.2d 719, 740 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968). This statement is no longer accurate. *See, e.g., Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490, 496 (7th Cir. 1986) ("[T]his duty does not come from § 10(b) or Rule 10b-5; if it did the inquiry would be circular. The duty must come from a . . . relation outside securities law.").

have established a number of factors to be used in evaluating those circumstances, including (1) the parties' relative access to the information; (2) the benefit the defendant derives from the sale of the securities; (3) the defendant's awareness of the plaintiff's reliance on the defendant in making investment decisions; and (4) the defendant's role in initiating the sale. *See Jett*, 840 F.2d at 1493;[26] *Rudolph*, 800 F.2d at 1043; *First Va. Bankshares*, 559 F.2d at 1314; *see also In re National Smelting of N.J., Inc. Bondholders Litig.*, 722 F. Supp. 152, 170-71 (D.N.J. 1989) (applying the same analysis). In addition, the Eleventh Circuit also considers (5) the extent of the defendant's knowledge; (6) the significance of the nondisclosure; and (7) the extent of the defendant's participation in the fraud. *Rudolph*, 800 F.2d at 1043.

Therefore, we must examine the facts of this case in light of these factors to determine whether a relationship giving rise to a duty to disclose existed between the Class and Arthur Young at the time of the nondisclosure. The first factor, the parties' relative access to information, supports a duty to disclose: Arthur Young was the source of some of the information that was not disclosed, e.g., the assumption about the Co-op's always having owned White Flame, and was aware of the critical information that if White Flame was given a lower value, the Co-op's

---

[26] In *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564 (9th Cir. 1990) (en banc), *cert. denied*, 111 S. Ct. 1621 (1991), the Ninth Circuit stated that it would no longer use the "flexible duty" test. *Id.* at 1570. However, this statement was limited to the scienter element of a Rule 10b-5 violation and thus appears not to alter the duty to disclose analysis.

net worth would be wiped out.[27] The second factor, the benefit the defendant derives from the sale, supports a duty to disclose in this case, but only weakly. Arthur Young did benefit from the sale of the demand notes, but only because the Co-op was a client and the demand notes were the Co-op's primary source of financing. This sort of indirect benefit, however, does not count for much.

The third factor, the defendant's awareness that the plaintiff relied on it in making investment decisions, also supports a duty to disclose here. Arthur Young knew that the demand notes were a risky source of financing and that bad news could cause a run on the Co-op. Conversely, Arthur Young must also have known that good news would ensure that people continued to buy demand notes. It is important to understand the nature of the Co-op's demand note clientele. The Class consists primarily of farmers, pensioners, and others who lived in and around Van Buren, Arkansas. Many of the Class members invested all of their savings in the Co-op's demand note program. These were not sophisticated investors. Thus Arthur Young had to know that good news about the Co-op's finances, or even the lack of bad news, would cause people to invest in the Co-op. As the Fifth Circuit has observed: "[T]he danger of misleading the public through a public accountant's knowing issuance of a false

---

[27] Although this factor supports a duty to disclose in this case, we do not afford it great weight in light of dicta found in the *Chiarella* decision: "A duty arises from the relationship between parties . . . and not merely from one's ability to acquire information because of his position in the market." 445 U.S. at 231-32 n.14.

opinion is obvious. A public accountant performs an important public function and must be aware that the public places great faith in the probity of its opinions." *Fine v. American Solar King Corp.*, 919 F.2d 290, 298 (5th Cir. 1990), *petition for cert. filed*, 59 U.S.L.W. 3615 (U.S. Mar. 4, 1991) (No. 90-1372), *motion to defer consideration of petition granted*, 59 U.S.L.W. 3769 (U.S. May 13, 1991).

Although the fourth factor, the defendant's role in initiating the transaction, does not support a duty to disclose because Arthur Young played no active role in the purchase of the demand notes, the final three factors do. The fifth factor, the extent of the defendant's knowledge, clearly weighs in favor of a duty to disclose in this case because it is undisputed that Arthur Young knew everything the Class wishes had been disclosed. The sixth factor, the significance of the nondisclosed matters, also obviously supports the duty to disclose. Finally, the seventh factor, the extent of the defendant's involvement, supports the duty as Arthur Young's involvement ranged from its conclusion about the acquisition of White Flame to its valuation of the plant to its actions at the Co-op's annual meetings. Therefore, based on these factors, Arthur Young had a relationship to the Class such that the Class had placed its "trust and confidence," *Chiarella*, 445 U.S. at 232, in the firm.

Arthur Young argues that it would be unfair to impose a duty to disclose on it in this case because it had no means to satisfy that duty. This claim is preposterous. Arthur Young knew the condensed financial statements were misleading because they did not discuss the problems with White Flame. At the annual meetings Arthur Young could have said something, but simply chose not

to. We wonder how difficult it would have been for Arthur Young, at either of the annual meetings, to inform the audience that there was something suspicious about the acquisition of White Flame, that Arthur Young had concluded that the Co-op had always owned the plant and relied on Kuykendall's numbers in valuing it, and that if White Flame were carried at a lower value, the Co-op might have a negative net worth. Given the importance of that information, the nature of the Co-op and the people who invested in it, the Co-op's location in a relatively rural area, and the interest of local news organizations in the Co-op's affairs, it seems sure that the Class would have heard what it now dearly wishes it had heard. Thus, Arthur Young could have satisfied its duty with perhaps two of the ten minutes it used to address the annual meetings in 1982 and 1983.[28]

---

[28] Arthur Young also relies on a line of Seventh Circuit cases for the proposition that it had no duty to disclose. *See DiLeo v. Ernst & Young,* 901 F.2d 624 (7th Cir.), *cert. denied,* 111 S. Ct. 347 (1990); *Latigo Ventures v. Laventhol & Horwath,* 876 F.2d 1322 (7th Cir. 1989); *LHLC Corp. v. Cluett, Peabody & Co.,* 842 F.2d 928 (7th Cir. 1988); *Barker v. Henderson, Franklin, Starnes & Holt,* 797 F.2d 490 (7th Cir. 1986). These cases, however, do not apply to the case at hand because they all involve claims for aiding and abetting Rule 10b-5 violations against accounting firms that did not blow the whistle on their clients, as opposed to the primary Rule 10b-5 liability asserted here. *See, e.g., Latigo Ventures,* 876 F.2d at 1327 ("It is not the law that whenever an accountant discovers that his client is in financial trouble he must blow the whistle on the client for the protection of investors. . . . "). Moreover, those cases feature vastly different factual circumstances and procedural postures. We do not believe these cases direct the result here.

Based on the unique facts and circumstances of this case, we hold that Arthur Young's relationship with the Class was such that it had a duty to disclose. Because of this duty to disclose, the Class was entitled to a rebuttable presumption of transaction causation. As Arthur Young did not attempt to rebut the presumption of transaction causation, the district court did not err in refusing to grant Arthur Young's motion for JNOV on the ground that the Class had not shown transaction causation.

3. Loss Causation

Arthur Young next argues that the district court erred in not granting its motion for JNOV on the ground that the Class failed to prove loss causation, that is, that Arthur Young's nondisclosure caused the Class, economic harm. *See supra* II.G.1. Arthur Young argues that the Class, economic harm was caused by the Co-op's bankruptcy, which, in turn, was directly precipitated by CFA's refusal to honor the Co-op's line of credit. Thus, Arthur Young argues, there is no loss causation because the bankruptcy was unrelated to the alleged fraud. Arthur Young's contention, while of some merit, is ultimately unavailing because of this court's broad test for loss causation. In our most recent Rule 10b-5 opinion, Chief Judge Lay observed: "Plaintiffs are not required to meet a strict test of direct causation under Rule 10b-5; they need only show 'some causal nexus' between [the defendant's] improper conduct and plaintiff's losses. . . . Traditional tests of proximate cause derived from tort principles are very much germane." *See Abbey v. Control Data Corp. (In re Control Data Corp. Sec. Litig.)*, No. 90-5107, slip op. at 7

(8th Cir. May 10, 1991) (citations omitted).[29] Thus, all the Class needed to show was that the Co-op's bankruptcy was somehow "related" to Arthur Young's nondisclosures. *See St. Louis Union Trust Co.*, 562 F.2d at 1049.

We believe the Class, evidence was sufficient on this issue. The Class showed that the Co-op would have had serious financial problems in 1981 had Arthur Young disclosed the information about White Flame. We are unable to say that Arthur Young's nondisclosure was unrelated to the Co-op's eventual bankruptcy.

Moreover, we note that one of Arthur Young's own exhibits refutes its contention that its nondisclosure was

---

[29] The district court's instruction on this issue was based on a theory of proximate cause:

> The fourth element that the trustee must establish by a preponderance of the evidence is that the defendant's conduct was the proximate cause of the injury to the plaintiff.
>
> In order for an act or omission to be considered a proximate cause of the injury, it must be a substantial factor in causing the damage, and the injury must have been either a direct result or a reasonable probable consequence of the act or omission.
>
> In order to satisfy this element, the plaintiff need not prove that the defendant's conduct was the only cause of the plaintiff's injury. It is sufficient if you find that the actions of the defendant were a substantial and significant contributing cause to the injury which the plaintiff suffered.

See 18 Tr. at 78.

unrelated to the Co-op's bankruptcy. That exhibit contains the bankruptcy court's order approving the Co-op's disclosure statement to its creditors, along with the statement itself and the bankruptcy plan of reorganization. The disclosure statement, which the Co-op's bankruptcy counsel prepared, states that there were three reasons for the bankruptcy filing: problems with the Co-op's management, the Co-op's reliance on demand notes for financing, and most importantly for our analysis, *the financial problems associated with White Flame. See* AY Ex. 223.

Because a reasonable jury could have found that Arthur Young's nondisclosure contributed to the Co-op's bankruptcy, and hence the Class' injury, we hold that the district court did not err in refusing to grant Arthur Young's motion for JNOV on the issue of loss causation.

4. Scheme to Defraud

Finally, Arthur Young argues that the district court erred because its instructions to the jury on the Rule 10b-5 claim were based on a scheme to defraud theory, that this theory is synonymous with a conspiracy theory, and that the district court had already determined that there was no conspiracy in this case. We do not believe that the limited references to scheme to defraud constitute reversible error in this case. Reading the instructions as a whole, *see Smith v. Hussman Refrigerator Co.*, 619 F.2d 1229, 1245 (8th Cir.) (en banc), *cert. denied*, 449 U.S. 839 (1980), it is clear both that the jury was not required to find any sort of conspiracy, and that Arthur Young's conduct satisfied the elements of a Rule 10b-5 violation.

5. Conclusion

In sum, the district court properly refused to grant Arthur Young's motion for JNOV on the Class' Rule 10b-5 claim. As is apparent, the key to our resolution of this issue is the conclusion that Arthur Young had a duty to disclose material information to the Class. This duty was a necessary prerequisite to the Class' nondisclosure theory and the resulting shift in the burden of proof on the issue of transaction causation. Arthur Young has argued vehemently against the existence of such a duty, claiming, among other things, that finding such a duty will increase the costs of all audits and lessen the amount of accounting oversight because firms will be unwilling to pay the higher prices. This policy-based rationale, however, does not comport with the law, nor with common sense. It must be kept in mind that whether or not a duty exists will be determined on a case-by-case basis, and that the duty to disclose imposed in this case was based on unique facts and circumstances. We certainly doubt that other accounting firms will engage in the type of conduct that Arthur Young did in this case. More particularly, we hope that Arthur Young will not.

G. Arthur Young's Contribution Claim

Arthur Young next argues that the district court erred in not submitting its contribution claim against the Co-op's Board of Directors to the jury. Arthur Young contends that it submitted a contribution instruction on the securities claims, but that the district court did not offer any such instruction. The district court, in denying Arthur Young's motion for a new trial on this issue,

concluded that Arthur Young did not make a specific objection at trial concerning the court's failure to instruct on the contribution claim, and moreover that the instruction Arthur Young allegedly tendered incorrectly stated the law. *Robertson IV,* slip op. at 37.

After reviewing the record, we conclude that the district court properly denied Arthur Young's motion for a new trial on this issue. On November 12, 1986, the district court informed counsel for all parties that they were to meet with his law clerks off the record and discuss the pros and cons of the proffered instructions, and that later all counsel would have an opportunity to go on the record in relation to the instructions. 16 Tr. at 201-03. On November 14, the district court conducted these on-the-record proceedings. At that time the district court stated:

> We are aware, in some detail, of the position of each of you, in relation to the issues that ought to be presented. What I'd like for you to do, because I understand that's all you need to do, in order to make your record to the Court of Appeals, is to tell me which of these instructions you think are wrong or should not be given, what additional instructions you think ought to be given and, very briefly, why. . . . Just do what you know is necessary, so that the Court of Appeals can see that you've made your record in relation to those instructions.

17 Tr. at 6. Counsel for Arthur Young objected to the proposed instructions as to contribution on Robertson's negligence claim against Arthur Young. *Id.* at 25. Counsel, however, mentioned nothing about contribution on the Class' securities claims. *Id.* at 18-26. The next day, counsel

was given another opportunity to go on the record about the instructions after the district court read them to the jury. Counsel raised several new objections at this point, but again mentioned nothing about contribution against the Board on the Class, securities claims. 18 Tr. at 92-94.[30]

Fed. R. Civ. P. 51 states: "No party may assign as error . . . the failure to give an instruction unless that party objects thereto before the jury retires to consider its verdict, stating distinctly the matter objected to and the grounds of the objection." The purpose of Rule 51 is to "compel litigants to afford the trial court an opportunity to correct any error in the instructions and also to prevent the losing party from obtaining a new trial through relying on a possible error in the original trial." *Johnson v. Houser*, 704 F.2d 1049, 1051 (8th Cir. 1983) (per curiam). As Wright and Miller have observed: "This purpose is well understood by the courts and the rule is applied in light of it. The necessity of a retrial is avoided when, by design or through sheer neglect, the losing party fails to make objection at the proper time." 9 C. Wright & A. Miller, Federal Practice and Procedure § 2551 (1971) (footnotes omitted).

We note that Arthur Young might have had a colorable claim for contribution against the directors. Ark. Stat. Ann. § 23-42106(c) specifically provides for contribution in the case of secondary liability for securities fraud.

---

[30] Our conclusion that Arthur Young did not object to the failure to instruct based on our review of the transcript is also supported by Arthur Young's failure to indicate in its briefs where it objected.

However, "[e]rror in the instructions not properly objected to is waived unless the error is plain error in the sense that a miscarriage of justice would otherwise result." *Johnson,* 704 F.2d at 1051. The plain error exception is limited to the "exceptional case, in which error has affected seriously the fairness, integrity or public reputation of judicial proceedings." *Id.* at 1052. This is not such an exceptional case, and no miscarriage of justice has occurred, because it is clear that much of the blame for the fraud in this case is placed properly on Arthur Young.

Putting this in some perspective, we note that the jury received 100 instructions in this case; eighty pages in the trial transcript are devoted to the district court's reading of those instructions to the jury. *Id.* at 4-84. Arthur Young now complains about the district court's failure to offer one instruction, when the firm had several days' notice as to when the instructions could be objected to, and at least two opportunities specifically to object to those instructions. Arthur Young could have objected to the failure, but did not. We conclude that the locus of the responsibility for the failure to instruct lies with Arthur Young, and not the district court, and thus that the district court properly denied the firm's motion for a new trial.

H. The Damages

1. Damages Evidence

Arthur Young next raises several issues concerning the damages awarded the Class. As an initial matter, Arthur Young challenges the competency of the Class'

evidence on damages. That evidence consisted of a computer run showing the demand notes purchased between April 22, 1982, when Arthur Young made its first presentation to the Board, and February 23, 1984, when the Co-op declared bankruptcy and the demand notes were frozen in the bankruptcy estate. The computer run showed that the notes purchased between those dates totaled $6,121,652.94. The jury awarded the Class exactly this amount after holding Arthur Young liable for state and federal securities fraud.

Arthur Young raises two main arguments with respect to the competency of the computer print-out. First, it contends that the print-out included the demand notes which had been redeemed within the ninety days before the Co-op's bankruptcy. Arthur Young argues that because these Class members received payment in full on their notes, they have no damages. The Class argues that these noteholders were included because their redemptions would be revoked as preferential transfers, ostensibly under 11 U.S.C. § 547 (1988). Therefore, the Class argues, these "preference" noteholders "were included in the Class as if they actually held notes." Robertson and Class Brief at 43. Robertson and the Class argue that there was no point in forcing Robertson to prosecute actions against all of these individuals if Arthur Young was found liable, because Robertson would just seek a decree to stand in shoes of those noteholders against Arthur Young.[31]

---

[31] The preference noteholders had redeemed $1,762,581.41 worth of notes. JA at 439.

Arthur Young's second argument is that the $6.1 million figure for the total number of demand notes sold between April 22, 1982 and February 23, 1984, also includes notes that were bought before April 22, 1982. If an investor partially redeemed a note during that twenty-month period, the remaining funds were re-issued as a new note. The Class' witness on the computer run admitted this at trial: "There was not [sic] assumption, no logic in the program at all to exclude anything at all except by the date of that note. . . . If the date of the note is 4-22-82. If that's what you call a rollover note, then yes, it would be included." 15 Tr. at 35.

We believe that both of these problems warrant reversing the award of damages in this case. Although the facts and the law certainly justify Arthur Young's liability for state and federal securities fraud, the damage award cannot stand. Arthur Young should not be charged with the $1.8 million the preference noteholders redeemed before bankruptcy, because at the time of trial the bankruptcy estate had not yet proceeded against them and there was no guarantee that the estate would succeed. Thus, until those noteholders suffer harm because of the bankruptcy, they have no damages.[32]

Arthur Young should also not be held liable to those whose initial investments in the Co-op occurred before

---

[32] We are unable to determine from the record exactly what has happened as regards the preference noteholders. At one point the Class appears to argue that Robertson has not filed actions against them. Robertson and Class Brief at 43. However, in another brief, the Class states that Robertson has filed actions against the preference noteholders. Class' Fees and Costs Brief at 12. This issue should be resolved on remand.

April 22, 1982. In no sense can those noteholders be said to have relied on Arthur Young's nondisclosure (for the Rule 10b-5 claim), nor can it be said that Arthur Young aided the Co-op's commission of securities fraud before it met with the Board (for the state claim). Therefore, we reverse the award of damages and remand for a new trial on this issue. Liability having been established, the Class need only provide evidence of the amount of demand notes purchased for the first time between April 22, 1982[33] and February 23, 1984. This figure will not include the demand notes redeemed within ninety days of bankruptcy unless the district court determines that those noteholders have been injured by the bankruptcy sometime between the original trial and the new trial on damages.

2. Measure of Damages

Arthur Young next argues that the district court erred in applying rescissory damages[34] instead of out-of-pocket damages on the federal securities claim.[35] The district

---

[33] If the Class had prevailed only on the Rule 10b-5 claim, the appropriate date would be May 27, 1982, the date of the Co-op's annual meeting.

[34] Rescissory damages "contemplate a return of the injured party to the position he occupied before he was induced by wrongful conduct to enter into the transaction" and are the monetary equivalent of the property at issue. *See* Black's Dictionary 354 (5th ed. 1979).

[35] Arthur Young concedes that rescissory damages are proper under the state securities fraud claim.

court's remedy functioned to transfer the demand notes from the noteholders to Arthur Young, which could then present the notes to the bankruptcy estate for payment. *See Robertson IV*, at 61-62. The district court selected this procedure because it greatly simplified a complex issue; benefited Arthur Young, in that the Co-op's bankruptcy estate had been significantly augmented by the various settlements in this case; and placed the Class in the same position it would have been in but for Arthur Young's fraud. *See id.* at 62-63.

Arthur Young contends that rescissory damages are only available where the defendant's benefit is greater than the plaintiff's harm. In making this argument, Arthur Young relies on *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972), in which the Supreme Court stated that "the correct measure of damages . . . is the difference between the fair value of all that the [plaintiff] received and the fair value of what he would have received had there been no fraudulent conduct." *Id.* at 155. Arthur Young ignores, however, a more recent Supreme Court case that also addressed the issue of damages in a Rule 10b-5 case. In *Randall v. Loftsgaarden*, 478 U.S. 647 (1986), the Supreme Court observed: "The issue whether and under what circumstances rescission or a rescissory measure of damages is available under § 10(b) is an unsettled one." *Id.* at 661. The Court, after noting *Affiliated Ute*, continued: "But there is authority for allowing the § 10(b) plaintiff, at least in some circumstances, to choose between 'undoing the bargain . . . or . . . requiring [the defendant] to pay [out-of-pocket] damages.' " *Id.* (quoting L. Loss, at 1133; latter bracketed material in original opinion). The Supreme Court,

however, expressly reserved decision on the point by assuming, *arguendo,* that a rescissory recovery "may sometimes be proper on a § 10(b) claim." *Id.* Therefore, contrary to Arthur Young's assertion, *Affiliated Ute* has not foreclosed the question of whether rescissory damages were appropriate in this case.

This court has previously observed that although Rule 10b-5 damages are normally measured by the plaintiff's out-of-pocket losses, the "out-of-pocket rule is not a talisman." *See Garnatz v. Stifel, Nicolaus & Co.*, 559 F.2d 1357, 1360 (8th Cir. 1977), *cert. denied*, 435 U.S. 951 (1978). In *Garnatz* we remarked further, "Indeed, this court has shown no hesitation in varying that measure when necessary on the facts of a given case," and concluded, "Our function is to fashion the remedy best suited to the harm." *Id.* The Ninth Circuit has even opined that whether rescissory damages are appropriate is within the district court's discretion. *See, e.g., Arrington v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 651 F.2d 615, 621 (9th Cir. 1981).

We believe that rescissory damages are best suited to the harm and to the facts of this case. Although we do not believe that simplification alone is a sufficient reason for applying this measure of damages, *see Green v. Occidental Petroleum Corp.*, 541 F.2d 1335, 1343 (9th Cir. 1976) (Sneed, J. concurring) ("Wrongdoing defendants should not be mulcted to make simple the management of a class proceeding under rule 10b-5."), we do believe that rescissory damages are fair to both parties: the Class receives funds immediately, and Arthur Young has an opportunity to recoup from the Co-op's bankruptcy estate the damages it paid to the Class.

Arthur Young argues that rescissory damages are only proper where the plaintiff is in privity with the defendant. Otherwise, Arthur Young argues, it would be required to perform an impossibility: rescind a transaction to which it was not a party. *See Huddleston v. Herman & MacLean*, 640 F.2d 534, 555 (5th Cir. Unit A Mar. 1981), *aff'd in part and rev'd in part on other grounds*, 459 U.S. 375 (1983). Arthur Young relies on a sophism to obscure the law, which is that when the circumstances of a case so dictate, privity is not required for the court to award *rescissory damages* in a Rule 10b-5 case. As the Eleventh Circuit has concluded: "Though we recognize the harshness of this result given that the defendants were not the actual sellers of the stock and therefore must 'rescind' by paying an amount they in fact never received, the substantial role played by the defendants provides adequate justification for the award." *Bruschi v. Brown*, 876 F.2d 1526, 1532 (11th Cir. 1989) (quotation omitted). *See also Gordon v. Burr*, 506 F.2d 1080, 1085 (2d Cir. 1974) (holding, in a Rule 10b-5 action, that "as between the innocent purchaser and the wrongdoer, who, though not a privy to the fraudulent contract, nonetheless induced the victim to make the purchase, equity requires the wrongdoer to restore the victim to the status quo.") We conclude that the district court properly determined that a rescissory measure of damages was appropriate based on the facts and circumstances of this case.

3. Calculation of Damages

Arthur Young next argues that even if rescissory damages were appropriate, the district court erred in its final determination of the damages because it included

interest on the notes. Rescissory damages are measured as follows: "[T]he plaintiff is entitled to a return of the consideration paid, reduced by . . . any 'income received' on the security." *Randall*, 478 U.S. at 656. Arthur Young argues that to measure the damages as of February 1984 for all of those who invested earlier than that, and hence earned interest, was error. We agree. Rescissory damages place a plaintiff in the same position she would have been in had she not been induced to enter into the transaction. *See* Black's Dictionary 354 (5th ed. 1979). Therefore, all the Class is entitled to is the return of its investment in the Co-op, not the investment plus its interest. Any interest the Class is entitled to would come as a result of this action, not the Co-op's program.

Unfortunately, we are not able to determine what actually happened as regards the interest on these notes. The Class, witness on the computer run did not testify on this issue and the record contains some confusing information. *See* JA at 440 ("The 'Amount Due' calculation represents the total amount of the notes plus simple interest on the notes at the rate indicated on the computer run minus the interest which was received by individuals on the notes."). Because it appears that the district court did not address this issue in its post-trial memorandum, *see Robertson IV*, at 61-66, and the Class has not addressed it in the briefs on appeal, we believe this is best dealt with on remand. Perhaps the awarded damages did not include interest and Arthur Young is wrong. Or it is possible that Arthur Young is raising this argument for the first time on appeal. On the record before us, however, we are unable to make any determination. Therefore, this issue should also be resolved on remand.

I. The Settlement Credit

The Class contends that the district court erred in crediting $5,744,800[36] in settlement proceeds against the $6,121,652.94 verdict against Arthur Young. During the course of the proceedings in this case, most of the defendants settled with Robertson and the Class. The settlements totaled approximately $8.2 million. Robertson and the Class agreed to split the settlement proceeds, allocating $5.6 million to the Class and $2.6 million to Robertson. It must be remembered that at this stage, the Class consisted of people who had purchased demand notes after February 15, 1980. The jury then determined that Arthur Young was liable for approximately $6.1 million in damages to the people who purchased demand notes after April 22, 1982. Because the district court fully credited the settlement proceeds against the jury's verdict, the Class argues, Arthur Young gets the benefit of settlements with Class members who had no claim against Arthur Young.

Under federal law, where a "settlement payment and the jury's award pertain[ ] inseparably to one and the same loss," the verdict must be credited with the payment on settlement. *See Kassman v. American Univ.*, 546 F.2d 1029, 1035 (D.C. Cir. 1976) (per curiam); *see also Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 50 (2d Cir.) (holding that Rule 10b-5 damages must be offset by amount of settlement), *cert. denied*, 439 U.S. 1039 (1978).

---

[36] This is more than the $5.6 million allocated to the Class before trial because it includes settlements reached during trial and other corrections made by the district court. *See* JA at 1434.

Under Arkansas law, settlement payments must be credited against a verdict if the settling party is jointly liable with the party against whom the verdict is rendered. *See* Ark. Stat. Ann. § 16-61-204 (1987) (formerly Ark. Stat. Ann. § 34-1004 (1947)). For joint liability, both parties must be responsible for the same injury. *Id.* § 16-61-201. Even if the parties' tortious acts are temporally separate, if they caused the same injury or loss, the parties are jointly liable. *See Merrill Lynch, Pierce, Fenner & Smith, Inc. v. First Nat'l Bank of Little Rock*, 774 F.2d 909, 916 (8th Cir. 1985). The district court concluded that Arthur Young and all of the settling defendants were joint tortfeasors, and granted the credit on that ground.

In this case, it is clear that the settlements were not all paid for the same loss. Some of the settling defendants, i.e., Co-op officers and directors, were released from various claims, including claims for common law fraud, negligence, and RICO violations. *See Robertson IV*, at 19. Therefore, under either the federal securities verdict or the Arkansas securities fraud verdict, the district court was not required to credit fully the settlement proceeds.

Having reached this conclusion, we still must address the proper allocation of the settlement proceeds. We must place the Class in the same position that it would have been in if not for Arthur Young's fraudulent acts. Therefore, on remand, the district court should first determine what the Class' damages are, as discussed above. The district court should then pro rata allocate the settlement proceeds to *all* members of the Class and

credit Arthur Young with the settlement proceeds allocated to the post- April 22, 1982, demand note purchasers. Arthur Young thus will not receive the benefit of settlements received by those who had no claims against it, but neither will the Class as a whole be unjustly enriched.

J. Conclusion

As regards the main appeal in this case, we affirm the district court's judgment in all respects except for the award of damages. We reverse that award and remand for a new trial on the issue of damages alone. At that time the district court shall conduct proceedings consistent with this opinion.

III.

Consolidated with the main appeal in this case is Arthur Young's appeal on interest, costs, and fees, and the Class counsel's appeal on the issue of his fees.

A. Interest

Arthur Young challenges the district court's calculation of pre- and postjudgment interest in this case. Because we have remanded for a new trial on the issue of damages, the proper interest will have to be recalculated. To guide the district court, we make the following observations. First, whether to award prejudgment interest is a matter of judicial discretion. *See Blau v. Lehman*, 368 U.S. 403, 414 (1962). Second, even though Arthur Young is entitled to credit against the verdict as discussed above,

Arthur Young is still liable for prejudgment interest on the entire verdict. Again, this is consistent with the rescissory measure of damages used in this case, and contrary to Arthur Young's suggestion, does not operate as a penalty. Third, 28 U.S.C. § 1961 specifically authorizes postjudgment interest, and we believe such interest is appropriate on both the damages and prejudgment interest in this case to compensate the Class for its investment and the interest the investment would have earned if not for Arthur Young's fraud. *See Kaiser Aluminum & Chem. Corp. v. Bonjorno,* 110 S. Ct. 1570, 1576 (1990).

B. Costs

Arthur Young next argues that the district court erred in awarding costs to Robertson and the Class. Arthur Young specifically argues that the district court erred in awarding costs to Robertson's counsel because he did not prevail on any claims and thus was not entitled to costs. *See* Fed. R. Civ. P. 54(d). Arthur Young overlooks the fact, however, that Robertson's counsel represented the Class before the Class counsel was appointed. Robertson and the Class also had a joint prosecution agreement, which provided that they would assist one another at trial. *See* JA at 2435. Having reviewed the transcript, we believe that much of what Robertson's counsel did at trial ultimately benefited the Class. In awarding costs to Robertson's counsel, the district court appears to have taken into consideration Robertson's counsel's lack of success on Robertson's claims, because it only awarded half of the costs requested. However, Robertson's counsel was only entitled to the costs reasonably associated with his representation of the Class. From the record we are

unable to determine whether the district court's costs award was reasonably related to the Class representation. Therefore, we reverse the award and remand for a redetermination of costs for Robertson's counsel.

Arthur Young also challenges the district court's award of costs to the Class. The decision whether to award costs to a prevailing party is committed to the discretion of the district court. *See Boyd v. Ozark Air Lines, Inc.*, 568 F.2d 50, 55 (8th Cir. 1977); Fed. R. Civ. P. 54(d). Arthur Young first contends that the district court's award of $8755 in costs was error because the Class did not meet its burden of proof with regard to evidence of costs. The Class did meet its burden of proof as regards $7378 incurred in providing the initial notice to the Class. *See* JA at 2355-60. Class counsel also attested to approximately $1500 in copying costs, although there is no supporting documentation. List of Co-op Litigation Expenses of Class Counsel, *reprinted in* Arthur Young Brief on Costs, Appendix D. We do not believe that the district court's final award of $8755, however, constitutes an abuse of discretion on the facts of this case.

Arthur Young also argues that the district court erred in finding that it was not a prevailing party or, alternatively, that the district court abused its discretion in denying the firm's petition for costs. We believe that the district court neither erred nor abused its discretion in denying costs to Arthur Young. Arthur Young next argues that the district court's failure to allocate costs among all forty original defendants constituted an abuse of discretion. We disagree, and note also that Arthur Young has failed to adduce any relevant precedent in support of this claim.

C. Fees

Arthur Young next challenges the award of attorney fees to Class counsel under Arkansas law. However, it appears from the record that the district court ultimately decided not to award any attorney fees under Arkansas law, because the larger net recovery was under the federal securities claim. In *Grogan v. Garner*, 806 F.2d 829 (8th Cir. 1986), we stated: "When a federal securities claim overlaps with a pendent state law claim, the plaintiff is entitled to the maximum amount recoverable under any claim." *Id.* at 839. In this case, the maximum amount recoverable was under the federal securities claim, and the district court thus did not award attorney's fees under Arkansas law. *See* Letter from District Court to all Counsel at 4 (Oct. 14, 1987), *reprinted in* Arthur Young Brief on Costs, Appendix B.

D. Class Counsel

Finally, Class counsel appeals the district court's reduction of his fee from the common fund established for the Class out of the various settlements. Class counsel requested that $335,000 of the common fund be allocated to him as a fee. The district court, after much reflection, concluded "given all the circumstances that only someone who 'lived through it' would know, that a reasonable fee for the services performed by [Class counsel] is $240,000." *See* Letter from District Court to all Counsel at 1 (Oct. 20, 1987), *reprinted in* Class Counsel's Brief on Fees, Addendum. After having reviewed the record and the district court's reasoning, although we believe there is

some merit to Class counsel's argument, we find no error in the reduction of his fee.

E. Conclusion

In sum, we affirm the district court's ruling on costs and fees except for its determination of Robertson's counsel's costs. On remand, the district court should recalculate the appropriate interest and redetermine the appropriate costs for Robertson's counsel.

IV.

Accordingly, the judgment of the district court is affirmed in part and reversed in part. In sum, we conclude that the district court: properly certified the Class; properly dismissed Robertson's breach of contract claim; properly granted summary judgment in favor of Arthur Young on the RICO claim; properly ruled that the demand notes were securities under Arkansas law; properly denied Arthur Young's motion for JNOV on the state and federal securities fraud claims; properly denied Arthur Young's motion for a new trial on the contribution issue; erred in part on the damages awarded; erred in granting Arthur Young full credit for settlement proceeds; and properly determined all costs and fees except for the fees for Robertson's counsel. This matter is remanded to the district court for further proceedings as discussed above.

A true copy.

Attest:

CLERK, U. S. COURT OF APPEALS, EIGHTH CIRCUIT.

APPENDIX B

Thomas E. ROBERTSON, Jr., As Trustee of the Farmer's Co-Op of Arkansas and Oklahoma, Inc.; Bob Reves; Frances Graham; Robert H. Gibbs, individually; Robert H. Gibbs, as natural guardian of his minor children Thomas A. Gibbs and Robert H. Gibbs, Jr.,; and Robert H. Gibbs, as Trustee of the Muskogee Internal Medicine Group Profit Sharing Funds, Plaintiffs, and Intervening Plaintiffs

v.

Jack E. WHITE; J.E.W., Inc.; Valley Feeds, Inc.; Gene Kuykendall and Fred Kuykendall, individually and d/b/a Kuykendall & Kuykendall, a partnership; Oran Moody, Jr. and Michael O. Moody, individually and d/b/a Moody & Moody, a partnership; Arthur Young & Company; Harry C. Erwin; Billy Joe Cabaniss, Jr.; Joseph F. Drozal, Jr.; Charles M. Hanson; Hal Brewer; Waldo Price; Truman O. Boatright; J.O. McClure; Hugh Winfrey, Jr.; M.V. Creech; Charles Bane; E.H. Pritchett, Jr.; Robert Plunkett; Ralph McClure; Jimmy Don Gooch; Jerry Metzer; W.J. Rimmer; Don Sebo; Joe Wayne Harris; James Willis; Dan Ray Core; Harold Davis; Jay Freeman; Jay Neal, Jr.; George Wagnon; Raymond (Jack) Clark; Carl Creekmore and Morril H. Harriman, Jr., individually and d/b/a Creekmore & Harriman, a partnership; E.J. Ball, Kenneth R. Mourton, and Stephen E. Adams, individually and d/b/a Ball, Mourton & Adams, a partnership; Kirit Goradia; Eddie Joe Smith; and John Does 1-20, Defendants.

Nos. 85-2044, 85-2096, 85-2155 and 85-2259.

United States District Court,
W.D. Arkansas,
Fort Smith Division.

April 4, 1986

MEMORANDUM OPINION

H. FRANKLIN WATERS, Chief Judge.

Defendants have filed numerous objections to Magistrate Ned A. Stewart, Jr.'s Proposed Findings and Recommendations denying their motions challenging the sufficiency of the plaintiffs' consolidated complaint, under Federal Rules of Civil Procedure (FRCP) Rule 12(b)(6). These objections are before this court pursuant to 28 U.S.C. Sec. 636(b)(1).

Plaintiffs in this action are Thomas Robertson, Jr., Trustee in bankruptcy for the Farmer's Co-op of Arkansas and Oklahoma, Inc., and Bob Reves, *et al*, a class of plaintiffs composed of Co-op members, distributees of unpaid Co-op patronage dividends and holders of Co-op demand notes.

There are 36 defendants, plus 1-20 "John Does", and, cumulatively, their motions cover the field, touching all 16 causes of action, whether asserted by the Trustee or by the class. The court has determined to address these questions collectively, and to address only those motions which question whether the complaint states a cause of action. Questions of limitations, etc., will be reserved for summary judgment should the parties wish to raise them.

A. PRELIMINARY DISCUSSION

Motions under rule 12(b)(6) of the Rules of Civil Procedure must accept all facts stated by the plaintiff to be true. *Jenkins v. McKeithen*, 395 U.S. 411, 421, 89 S.Ct. 1843, 1848-49, 23 L.Ed.2d 404 (1969). The court notes this elementary point for two reasons. First, in many cases, defendants' motions took extended issue with the truth of statements in the plaintiffs' complaint. In olden days, 12(b)(6) motions were called demurrers. A demurrer which took issue with matters raised by the complaint, or which sought to enlarge the complaint by pleading additional facts, was called a "speaking demurrer". It was customary for courts to deny such pleadings because they spake. In this case, if defendants' demurrers could talk, what tales they would tell! Defendants have invited the court to peruse argumentative exhibits consisting of publications from accounting societies, affidavits from parties, depositions, interrogatories, resumes, job descriptions, statements of witnesses, and you name it. Plaintiffs have filed responses including exhibits ranging from Business Week opinion pieces, affidavits from eminent accountants, letters from their clients, legal bills, newspaper articles about Capitol Hill doings, etc. As a consequence, the file of motions, briefs, and exhibits is some two feet thick. The primary reason, therefore, for stating such an elementary point at the head of this opinion is to express some measure of the court's irritation at the flouting of Rules of Civil Procedure by counsel on both sides in this case.

In addition, the court perceives that in this case a large percentage of parties on both sides are said to be relatively unsophisticated litigants, at least in the sense

that they probably have had few contacts with the civil court system. The court desires that all parties reading this opinion be aware that in making a recital of the allegations of the plaintiffs' complaint, the court in no way indicates a belief in the statements, it rather *assumes* their truth for purposes of argument.

Conley v. Gibson 355 U.S. 41, 45, 78 S.Ct. 99, 101-02, 2 L.Ed.2d 80 (1957) established the standard this court must use in determining the validity of plaintiffs' claims, upon a defendant's Rule 12(b)(6) motion: "In appraising the sufficiency of the complaint we follow, of course, the accepted rule that a complaint should not be dismissed for failure to state a claim unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief." This standard is, of course, quite liberal. The court is obliged to construe the complaint so as to do substantial justice. FRCP Rule 8(f). The purpose of pleading is to facilitate a proper decision on the merits. *Maty v. Grasselli Chemical Co.*, 303 U.S. 197, 58 S.Ct. 507, 82 L.Ed. 745 (1938). The Rules exist to "secure the just, speedy, and inexpensive determination of every action." FRCP, Rule 1. These are preliminary observations to a discussion to be undertaken later with respect to the sufficiency of the plaintiffs' fraud complaints. A too-strict, fine-toothed combapproach to the plaintiffs' complaint leads only to prolixity and delay. The court is not inclined to dismiss a complaint on pleading points. However, where the court is of the opinion that the complaint does not and cannot state a cause of action under state or federal law, then there is no point in passing the matter into discovery. As the saying goes, you should never try to teach a pig to sing: it

can't be done, and it annoys the pig. This opinion will therefore only concern itself with whether the various counts can possibly state causes of action against the defendants under *any* view of the complaint.

In addition to motions brought under FRCP Rule 12(b)(6), several defendants have raised serious limitations issues. To the extent that the complaint obviously sets forth matter beyond the relevant period of limitations, the court feels that the plaintiff *should* have pleaded acts or circumstances which take the matter past the bar by limitations. *Stewart Coach Indus. Inc. v. Moore,* 512 F.Supp. 879 (D.Ohio, 1981). Because this was not done, the court prefers to take these questions up on summary judgment. Local Rule 29 requires summary judgment movants to append to their motion statements of facts not disputed. The court feels that a Rule 56 motion filed conformably with local rules will best determine questions of limitations as justly, speedily and efficiently as possible. Similarly, certain "honorary" directors question their place in the lawsuit. The court is sympathetic to their argument. The complaint, however, states that they are directors, and for present purposes the court is inclined to keep them in the lawsuit until such occasion as the question can be reduced to agreed statements of fact, as *per* summary judgment. With these reservations in mind, the court will proceed to redact the plaintiffs' complaint in narrative form as background for discussing the causes of action expressed in the consolidated complaint.

B. PROCEDURAL BACKGROUND AND NARRATIVE SUMMARY OF PLAINTIFF'S COMPLAINT

On February 23, 1984, the Farmer's Co-op of Arkansas and Oklahoma, Inc., filed for bankruptcy under Chapter XI of the bankruptcy code. Nearly a year later, the Trustee filed an action on behalf of the Co-op, its members, and demand noteholders, charging individual managerial employees of the Co-op, all of the Co-op's professional advisers (*i.e.*, accountants and lawyers,) and all of the Co-op's directors during the 1974-84 period. The suit charged defendants with fraud, negligence, recklessness, contract, securities, and R.I.C.O. violations, *inter alia*, and sought restitutionary, compensatory, statutory, and punitive damages. The defendants promptly moved the court for an order dismissing the Trustee's claims on behalf of the members and demand noteholders, alleging that he lacked standing to assert such claims. *Caplin v. Marine Midland Grace Trust Co.*, 406 U.S. 416, 92 S.Ct. 1678, 32 L.Ed.2d 195 (1972). Bob Reves and other members and demand noteholders filed a petition to intervene, and sought permission to assert a class action against the defendants named in the trustee's complaint. The complaints of the trustee and of the intervening class were consolidated. The District Court, on September 27, 1985, approved the recommendations of the magistrate and certified the class.

In 1952, the Co-op named Jack White its general manager. One gathers that it was not a large business at the time, but that it grew to considerable size under his management – becoming one of the largest businesses in Crawford and Sebastian Counties, Arkansas. It occupies a large commercial facility in Van Buren near the Arkansas

River, and operates extensive interests throughout western Arkansas and eastern Oklahoma.

Jack White served as general manager of the Co-op until 1983. His tenure was cut short by a federal indictment and conviction for tax fraud. The grand jury in Fort Smith indicted White and the Co-op's long time auditor, Gene Kuykendall, in September, 1980. The indictment alleged that for a period of time in the mid-1970's, White engaged in a pattern of self-dealing with the Co-op, and that Kuykendall concealed his predations by juggling the books. The petit jury convicted White and Kuykendall on all counts in January, 1981. White and Kuykendall remained free on bond pending their appeal. The conviction was affirmed by the Eighth Circuit in February, 1982.

White remained as general manager of the Co-op throughout this period until he surrendered himself for a six months' term of imprisonment. The plaintiffs' complaint alleges that he still retained effective control of the Co-op even while in jail (Par. 139). Kuykendall had audited the Co-op's books until 1977, when the Fort Smith firm of Moody and Moody assumed those duties. Kuykendall remained associated with enterprises owned or managed by White, specifically a corporation known as White Flame, Inc., whose misfortunes form the core of both the trustee's and the class' causes of action. All through the period preceding the Co-op's bankruptcy, the complaint states that Jack White dominated the Co-op board, and was able to perpetrate frauds upon the Co-op either through deceit practiced upon the board or through the active collusion of board members, some of whom were business associates of White's and some of whom received low or no-interest loans from the Co-op

for investment opportunities in non-agricultural enterprises (Par. 133, 146).

The board appeared to have the highest confidence in Jack White. Subsequent to his indictment they voted to pay the legal fees and expenses incurred by White and Kuykendall and spent over $300,000.00 doing so in a losing effort. Undaunted, even after conviction, members of the board approached local news and television media claiming that White's offense was at most a technical violation of the tax laws and that no transaction detrimental to the Co-op had been shown (Par. 81). White was permitted to remain as general manager and fiduciary of the Co-op after conviction and was even given a six-month "leave of absence" to serve his sentence. (Par. 139).

Two years before the conviction, White and Edwin Dooley were involved in an enterprise called Big D & W Refining and Solvents, Inc. Each owned half the shares. Dooley was President and White was secretary of the corporation. (This company later changed its name to White Flame Fuels, Inc., and for sake of consistency, will be referred to as White Flame throughout this opinion.) White Flame decided to build a plant to produce gasahol, and began building the facility in June, 1979 (Par. 25). A few months later, White bought Dooley's shares and agreed to hold Dooley harmless for the $1.2 million they had borrowed to finance the plant. The White Flame balance sheet for 1979 was then prepared by Kuykendall, and showed a net worth of $350,000, attained by carrying the gasahol equipment and plant at their purported cost of $1.5 million. White Flame was insolvent at the time (Par. 27). Apparently, the plant and equipment were poorly designed and grossly inefficient.

White experienced great difficulty attracting capital to continue operating White Flame. Conventional lenders wouldn't touch it. The Farmers Home Administration advised him that the plant would have to produce at 90% capacity for sixty days before it would be eligible for financing. The best the plant could produce was 25% capacity. White continually solicited FmHA financing from January, 1980, until October, when he learned that his application would no longer be considered. In the meantime, White induced Co-op to lend White Flame money to operate its plant, and gave the Co-op his guaranty for low-interest, unsecured loans eventually amounting to \$3.8 million. The plaintiffs charge that these loans were either completely unauthorized or were made by deceiving the board (Par. 33).

By the end of 1980, therefore, Jack White was in financial straits because of White Flame. Because he had guaranteed White Flame's debt to the Co-op, he stood to lose his entire personal fortune if the Co-op called in the loans. The complaint alleges that certain defendants conceived a plan to have the Co-op buy White Flame from White in return for a release of his nearly \$4 million in personal obligations to the Co-op.

At the December 11, 1980, board meeting, the Co-op's general counsel, Carl Creekmore, announced his resignation. The following day, Creekmore filed a lawsuit for the Co-op against White. The complaint in the lawsuit was prepared by White's counsel in the criminal tax fraud case, Ball and Mourton of Fayetteville, Arkansas. Ball and Mourton, had been tax counsel to the Co-op since 1974. They had represented the Co-op in tax deficiency proceedings stemming out of the IRS investigations which

culminated in the indictment of White and Kuykendall. Perhaps as a result of that association, they became White's personal counsel in the criminal case. The complaint alleges that Ball and Mourton unethically represented the interests of both the criminal (White) and his victim (the Co-op) and ignored their fiduciary duties to the Co-op.

Shortly after Creekmore filed the complaint, Ball and Mourton mailed Creekmore White's answer and a proposed consent decree. Creekmore filed the answer and secured the chancellor's approval of the decree. The effect of the decree was to transfer White Flame to the Co-op and to release White from his guaranty on the $4 million in loans and interest owed to it. The complaint states that certain documents were altered to make it appear as though the Co-op had bought White Flame ten months earlier, in February, 1980 (Par. 43).

As a proximate result of this transaction, the Co-op relinquished an asset purportedly worth $4 million (White's guaranty) for assets worth only $500,000. These assets required further investment to become productive, and the Co-op spent $1.8 million for that purpose. The acquisition of White Flame pushed the Co-op to the point of insolvency, and disabled it from continuing in business unless it misstated the value of the White Flame assets (Par. 44).

During this time Oren Moody, of the firm of Moody & Moody, CPAs, served as the Co-op's independent auditor. He undertook to audit the Co-op's books as of December 31, 1980, and presented his report to the Co-op board in March, 1981, after White and Kuykendall had

been convicted of self-dealing and "cooking the books" in the federal criminal tax trial. The plaintiffs state that Moody's report was negligently and fraudulently misleading to the Co-op and investors, principally existing and future holders of the Co-op demand notes. Particularly, they allege that Moody reported the $4.1 million receivable from White Flame to the Co-op at full value when he had no reason to believe it was collectable; that he failed to report White Flame's $1 million loss for 1980 on the Co-op's income statement, thereby allowing the Co-op to show a profit when it had in fact lost substantial sums; and that Moody failed to "go behind" White Flame's 1980 audit, which was fraudulently prepared by Kuykendall, thereby rendering his own opinion an instrument of fraud against the Co-op, its members and investors.

Plaintiffs charge that Kuykendall's audit of White Flame (which was incorporated into the Co-op audit,) falsely reported the net worth of White Flame's assets as $4 million when they should have evaluated them at $500,000. The plaintiffs also claim that Kuykendall fraudulently reported that White Flame had lost only $80,000 during the first year, when in truth it had lost over a million dollars. These fraudulent audit findings were reported as true in the Moody audit, and materially misled Co-op members and investors, due either to Moody's negligence or fraudulent connivance.

The plaintiffs further allege that the Moody audit misled members and investors by reporting only 20% of the outstanding Co-op demand notes as current liabilities. The demand note program started in 1959. The Co-op solicited individuals to invest money, and in return

the Co-op would give them promissory notes, payable on demand, carrying an interest rate higher than that available from local banks and savings institutions. The higher interest made the opportunity attractive to investors; the lack of F.D.I.C.-type insurance made it perhaps less attractive. One gathers from the complaint that individuals would invest in such a program only if the enterprise looked safe from a business standpoint. In this connection, financial reports and audits were important influences in an individual's decision to invest his money in Co-op notes. One infers that an accurate accounting of current assets and liabilities would be important, since the Co-op's ability to promptly retire current liabilities depended on the depth of its current assets. Reporting the demand notes as 80% long-term liabilities painted a roseate picture of the Co-op's ability to absorb a "run" by investors in its savings program.

Until 1964, the Co-op had, in fact, reported the demand notes as 100% current liabilities. Beginning in 1965, however, Co-op statements accounted the notes as one-third current, two-thirds long term. In 1973, this was changed to one-fifth. White and Kuykendall initiated this misstatement, and in 1977, when Moody became auditor, he continued it. When Arthur Young & Co. became auditor in 1981, it corrected the misstatement and began reporting the demand notes as 100% current liabilities again. But for the 1980 audit, Moody reported the Co-op's current liabilities at $11 million against current assets of $13 million. The complaint suggests that a true picture would have shown the Co-op backing up to $18 million in current liabilities with $13 million in current assets.

Arthur Young took over the Co-op's audit for the year ending December 31, 1981. The plaintiff trustee and investors claim that Arthur Young materially misled the Co-op and its members/noteholders by inflating the value of gasahol assets owned by White Flame. The books reported those assets at a value exceeding $3 million, whereas in fact they were worth less than $500,000. Arthur Young's performance is termed negligent or fraudulent for not getting an appraisal of White Flame's properties. Instead, they arbitrarily decided to treat the gasohol plant as having been owned by the Co-op from the start of construction even though they knew that this was not the case (Par. 60). The plaintiff alleges that Arthur Young considered requiring the Co-op to write the White Flame assets down to their net realizable value, and in the absence of compliance, to issue an adverse opinion. Arthur Young's auditors are charged with knowing that White and Kuykendall had deliberately cooked White Flame's books to make it appear that items properly chargeable to expense were added to the capital asset account. For these reasons and others, the plaintiffs allege negligence, gross negligence and fraud against Arthur Young.

Arthur Young gave the Co-op an unqualified opinion in 1981 and 1982, and presented the same to the Co-op's annual meetings in March 1982, and 1983. The actual opinions footnoted a reservation that there was "some doubt as to the recoverability of the Co-op's investment in White Flame", an investment which, by the time of the March, 1983, meeting, had grown to over $7 million. The Co-op, with the knowledge and participation of Arthur Young, issued a "condensed" version of its financial

reports to its members and noteholders. The "condensed" reports, which were known to Arthur Young and the management clique of the Co-op to be materially misleading, contained no reservations concerning the recoverability of the White Flame investment. Management circulated a report to the members and to the public that the Co-op was financially sound throughout 1981 and 1982, when it was in fact insolvent.

For some time, the Arkansas Securities Department had been concerned about the Co-op's demand note investment program. As early as the mid-70's, it had written the Co-op and demanded that the notes be registered as securities. In March, 1974, the department demanded that White disseminate accurate financial information to current and prospective members and investors. White misled the department, saying that the Co-op did so, when in fact the reports it circulated were condensed reports such as Moody's, which in themselves were misleading because they contained no explanatory notes.

In May of 1983, the Securities Department demanded that the Co-op cease accepting further investments in demand notes until appropriate disclosures were made. Attorney Morril Harriman counseled the Co-op's general manager (then Fred Howard) to sign an agreement to comply, and then counseled him to ignore the agreement and to accept notes. It is alleged that, if access to demand note capital had been denied the Co-op, it would have folded then there. Harriman represented to the Securities Department that the Co-op was solvent, when, in fact, it was not.

In October, 1983, the department permitted the Co-op to issue demand notes and "re-investment certificates" on the condition that persons be issued an offering statement at the time of initial investment or monthly reinvestment of interest. The new general manager, Eddie Joe Smith, knowingly permitted members and investors to invest and reinvest their money in the Co-op without showing them the offering statement. Had he shown them the offering statement (which was so worded as to make it unlikely that any person would choose to invest), the disclosure would have caused a run on the Co-op which it could not have absorbed.

A few months later, the Co-op declared itself bankrupt and entered re-organization proceedings.

The defendants in this action, thirty-six by present count, array themselves into three basic groups. The first group may be termed the management group, and consists of Jack White, Gene Kuykendall, Comptroller Kirit Goradia, General Manager Eddie Joe Smith, as well as enterprises owned or controlled by White, such as J.E.W., Inc., White Flame Fuels, Inc., and Valley Feeds. Basically speaking, members of this group are said to have directly assisted White in looting assets of the Co-op by fraudulently making book entries and concealing White's self-dealing. In this connection, the complaint speaks of Kuykendall and Goradia primarily. White's three corporations are alleged to have looted Co-op assets. Eddie Joe Smith is alleged to have conspired with White (Par. 15) and to have fraudulently prolonged the life of the Co-op for the purpose of attracting investments in the demand

note program, despite a knowledge of the Co-op's insolvency, and the certain failure of any investment made in it.

The second group of defendants may be referred to as the professional group, and consists of accountants with Moody & Moody, and Arthur Young and Co. A number of attorneys are also included among this group, specifically E.J. Ball and Ken Mourton, and through them the firm of Ball, Mourton & Adams, and Carl Creekmore and Morril Harriman, and through them Creekmore and Harriman. All are said to have conspired with Jack White, except perhaps Steven Adams, who practices with Ball & Mourton (Par. 15).

The third group consists of the Co-op directors. These number twenty-one parties, two of whom are dead. The complaint suggests that some directors were culpable of fraud and directly connived with White; and that the remainder were negligent, grossly negligent and reckless in their stewardship.

C. PLAINTIFFS' CAUSES OF ACTION

COUNT I: RETURN OF PROFESSIONAL FEES PAID TO LAWYERS' ACCOUNTANTS

Count I seeks return of legal fees and expert witness fees incurred in the defense of White and Kuykendall, paid by the Co-op to the firm of Ball and Mourton, attorneys at law, and Arthur Young & Co., CPA's. On September 4, 1980, the federal grand jury indicted Jack White and Gene Kuykendall. The gist of the indictment was that the Co-op's tax return had been falsified by

mislabelling certain payments to and from the Co-op as patronage income and dividends. The indictment charged that White engaged in a course of self-dealing with the Co-op, and that White and Kuykendall had conspired to conceal from the IRS the true nature of White's transactions with the Co-op. Specifically, the government charged that by manipulating the books and records of the Co-op, White and Kuykendall masked the true nature of an Industrial Development Bond issue, and disguised payments of taxable compensation to White as tax-exempt interest.

On September 8, 1980, the Co-op's Board of Directors met and unanimously passed a resolution expressing its confidence in White and Kuykendall. Later, on December 11, 1980, the Co-op board, in a regular meeting, voted to pay White's and Kuykendall's legal expenses. The criminal trial commenced January 5, 1981, and the jury returned a verdict of guilty on January 23. The defendants appealed their conviction to the court of appeals, which heard arguments on December 11, 1981, and dismissed the appeal on February 26, 1982. The opinion of the Eighth Circuit stated: "The record clearly demonstrates that White and Kuykendall manipulated the Co-op's finances to serve their own personal ends, and that they distorted the Co-op's records of receipts subject to corporate income tax." *United States v. White*, 671 F.2d 1126, 1134 (8th Cir. 1982). The opinion relates, *inter alia*, that the Co-op paid interest to White in the amount of $149,600 in 1975 and 1976, and incurred a $50,000 fee to underwriters, as a result of a transaction in which the Co-op lent White $1,500,000, interest-free, in order to buy an

equivalent amount of its bonds to finance construction of new facilities.

Plaintiffs charge that it was wrong for Ball and Mourton, the defense attorneys, to take legal fees from the Co-op because the firm also represented the Co-op on tax matters, and therefore owed it a fiduciary duty to protect its interests. The complaint charges that Ball and Mourton knew or should have discovered that White and Kuykendall had impermissibly acquired Co-op assets, that defendants' course of conduct was self-interested, and that the Co-op, as victim of their predations, should not be expected to fund the defense of the wrongdoers. The White and Kuykendall defense team hired accountants with Russell Brown & Co. (later Arthur Young) to give expert testimony for the defense during the criminal trial. The Arthur Young accountants are charged with knowledge of White's and Kuykendall's self-dealing activities, making their receipt of fees from the Co-op wrongful.

In sum, the attorneys and accountants are charged with knowing that White's and Kuykendall's activities in no way benefited the Co-op, and were not intended to, and that such actions could not constitute, on the part of White and Kuykendall, a good faith discharge of their duties to the corporate entity. The complaint in Count I charges that White and Kuykendall unlawfully obtained $300,000 of Co-op funds for their defense. The complaint seeks actual and punitive damages for the Co-op and the class from White and Kuykendall on the theory that the expense of defense was personal to them and not one properly payable by the Co-op; from defendants Creekmore and Harriman, the Co-op's general counsel, on the theory and they should have advised the Board not to

approve this outlay, such failure being negligent or fraudulent; from the directors, on the theory that they negligently or fraudulently approved the disbursement of Co-op funds; and from the defense attorneys and accountants, on the theory that they were *particeps* in the receipt of Co-op funds on behalf of White and Kuykendall, and thereby breached their own personal fiduciary duties (at least in the case of Ball & Mourton), or assisted White in violating his own fiduciary responsibilities.

The lawsuit purports to seek recovery under this court on behalf of both the Co-op and class. At least insofar as this count is pressed by the class, it must be dismissed for lack of standing. The right of action against officers and directors to redress wrongs to the corporation resides in the corporation and, except as statutes might otherwise provide, the right is the exclusive property of the corporation. *Red Bud Realty Co. v. South,* 153 Ark. 380, 396, 241 S.W. 21 (1922). A wrong done to a corporation is one done to the entity and not to the shareholders distributively. *Jones v. Foster,* 70 F.2d 200, 205 (4th Cir. 1934), *cert. denied,* 293 U.S. 558, 55 S.Ct. 70, 79 L.Ed. 659 (1935). Stockholders may bring derivative suits, of course, but such suits are equitable in nature even if premised on legal grounds. *Taylor v. Terry,* 279 Ark. 97, 649 S.W.2d 392 (1983). As vehicles of equity, punitive damages are not available. Jury trials, also, are not available in equity for the claims of shareholders. To include class claims in this count will entail only confusion. Generally, therefore, where the corporate entity has already sued, and there is no claim that the interest of the shareholders was not adequately represented by the corporation, it is error to allow a separate action brought by

shareholders to proceed. *See, e.g., Vanderboom v. Sexton,* 460 F.2d 362 (8th Cir. 1972).

The class argues that Arkansas departs from the rule disallowing shareholders to sue in their own name for damages suffered by the corporation, *citing inter alia, Henderson v. Rounds and Porter Lumber Co.,* 99 F.Supp. 376 (W.D.Ark.1951); *In re Ozark Restaurant Supply Co., Inc.,* 41 B.R. 476 (Bankr. W.D.Ark.1984); *Sternberg v. Blaine,* 179 Ark. 448, 17 S.W.2d 286 (1929); *Bank of Commerce v. Goolsby,* 129 Ark. 416, 196 S.W. 803 (1917); and *Bank of Des Arc v. Moody,* 110 Ark. 39, 161 S.W. 134 (1913). These cases are distinguishable. *Henderson* and *Ozark Restaurant* were creditors' actions against parties who had abused the corporate form to defraud trade creditors. Both cases deal with controlled or subsidiary organizations which were forced to sell their wares to the parent at artificially low prices, by which practice the subsidiary became insolvent. The induced insolvency worked a fraud on those suppliers who extended credit to the subsidiary. In *Henderson* the creditor himself, and in *Ozark Restaurant,* the bankruptcy Trustee, were permitted to undo the frauds perpetrated through the subsidiary. These authorities do not overrule *Red Bud Realty v. South, supra.* They are distinguishable. They do not suggest that a shareholder in a corporation may directly sue third parties who supply defective goods or services to the corporation. Such a holding would introduce chaos and mischief. Suppliers of defective goods and services could conspire to have owners of a single share file actions against them in equity court to avoid juries and penalties.

The remaining three authorities cited by plaintiffs, *Sternberg v. Blaine, Bank of Commerce v. Goolsby,* and *Bank*

of Des Arc v. Moody, supra, are bank failure cases from early in the century which held that bank directors were liable to shareholders and depositors for negligent supervision ending in insolvency. None of them concerned a matter such as the one here in suit; that is, a shareholder's personal right to sue a third party who allegedly owes a corporation some money or who provided faulty goods or services to the entity. The court is convinced that such an action by a shareholder is purely derivative. As a derivative action, it cannot proceed where the corporation or its trustee have already filed the claim. The class' cause of action under Count I is hereby dismissed.

In further support of its decision, the court notes that in 1965, the Arkansas General Assembly passed the Model Business Corporation Act. The state's organic corporation law, to the extent that it once might have allowed shareholders to sue third parties, now provides that such actions proceed as derivative suits. Ark.Stat. Ann. Sec. 64-223 (1980 Repl.). While there may be shareholder actions which are personal in nature, rather than derivative, such is not the case in this instance. As Henn, *Law of Corporations,* 2d Ed H.B., Sec. 360 at 757 (1970) says:

> "No simple and foolproof method exists whereby a derivative action may be distinguished from a shareholder's direct or individual action. But generally speaking, the breach of the shareholder's membership contract gives rise to a direct or individual action while a wrong to the incorporated group as a whole (*i.e.,* breach of some duty to the corporation) is the basis for a derivative action."

If the cause of action expressed in this count belongs to anyone, it belongs to the trustee. Defendants attack the trustee's complaint on the grounds that it states no cause of action, and that even if, *arguendo*, a claim is stated, it is barred by the three year statute of limitations for fraud. Without going into detail, the court is convinced that defendants' arguments are meritless.

There is little doubt that a corporation may pay attorney's fees for the criminal defense of directors and officers. When the corporation agrees to pay those fees in advance, the law requires the officer or director so benefitted to agree to pay the money back in the event that his actions were not found to have been in good faith. Ark.Stat.Ann. Sec. 64-309(E). It does not appear that this was done. Given the tenor of the Eighth Circuit's opinion that White's and Kuykendall's acts were directed towards "personal ends," *United States v. White*, 671 F.2d at 1134, a reasonable director would have concluded that repayment by the defendants was in order. That this course was not pursued gives the trustee the right to proceed against the directors under Arkansas law. Furthermore, the third parties involved in this case knew or should have known, under the pleadings, that they were accepting money from the Co-op, to defend Co-op fiduciaries, for acts which, if proven, constituted a serious breach of fiduciary duties. In *Raines v. Toney*, 228 Ark. 1170, 313 S.W.2d 802 (1958), the court held that persons who assist a fiduciary in the breach of his obligations are liable to the persons or entities so damaged.

The limitations arguments of the defendant lawyers and accountants have been noted, but are not now decided since the question when the limitations period

actually began to run against the Co-op may be one for the jury, in the absence of undisputed facts. *See, e.g., Vanderbloom v. Sexton*, 460 F.2d 362, 364 (8th Cir. 1972) (semble). If facts are undisputed, as well as inferences to be drawn therefrom, we may take this up in summary judgment form.

Defendants' motions to dismiss the trustee's claim are hereby overruled.

COUNT II: FRAUD AND VIOLATIONS OF FIDUCIARY DUTY RELATING TO THE GASOHOL PLANT

Plaintiffs' second cause of action attacks the transaction by which White Flame Fuels was transferred to the Co-op. The complaint charges Jack White and his related enterprises with fraud, and also states claims against Kuykendall and his partners, the Co-op's directors, Ball and Mourton, Goradia, Creekmore and Harriman. As previously related, the complaint charges that White Flame, whose asset values were inflated eight-fold by Kuykendall, was passed to the Co-op in return for the cancellation of $4 million of indebtedness owed by it and White. The complaint includes an allegation that attorneys and White, along with attorneys Carl Creekmore, and the firm of Ball & Mourton, conspired to commit a fraud on the Crawford County Chancery Court as an element of their plan. As a result of these actions the complaint seeks damages "for all losses sustained by the Co-op". (Consolidated Complaint, Count II, p. 23).

For reasons discussed in the court's opinion with respect to the class's standing to bring a complaint

against third parties, *supra,* the court dismisses that part of Count II which seeks damages for the class.

Defendants vigorously argue that the entire complaint charging fraud in Count II should be dismissed for failure to plead reliance and for failure to plead specific facts under Rule 9(b). The court conceives this as a very considerable grievance for certain defendants, who claim not to know what they are charged to have misrepresented, and which persons, if any, relied to their detriment upon statements made by them.

It is a matter of some debate in the courts whether Rule 9(b), which requires that fraud be specifically pleaded, is relaxed by Rule 8, which demands that only a short statement of the claim be required: or whether detailed narrative pleadings are required in fraud cases notwithstanding the notice pleading ordinarily required under Federal Rules. In a wide-spread case of alleged fraud, such as this one, spanning five years and involving thousands of parties, as many as 57 of whom are defendants, a specifically pleaded complaint could run into the hundreds and hundreds of pages. There have been any number of pained remarks by defense counsel concerning the length of this "abbreviated" complaint, so as to persuade the court that, if the plaintiffs had chosen to plead with that specificity demanded by the defendants, the court should now be having to pass on motions to strike. *E.g. Iafrate v. Compagnie Generale Transatlantique,* 12 FRD 71 (S.D.N.Y. 1951).

The court therefore feels that a balance needs to be struck in fraud cases of this kind. The court believes that to the extent that a fraud complaint identifies with a fair

amount of particularity the transactions being questioned, the dates upon which they occurred, and the principal actors involved, the pleadings should pass muster. The court has little difficulty following the thread of plaintiffs' complaints. If it were required to put itself in the position of a party summoned to defend this action, the court believes that it would be able to identify the relevant issues and prepare an apt answer and defense. To require much more would be wasteful, and, as this case proves, dilatory.

It is probably not even advisable that a fraud plaintiff plead with greater particularity than was done here. Plaintiffs have the heavy burden of proving fraud by clear and convincing evidence. *Bradley v. Southern Farm Bureau Casualty Co.*, 392 F.Supp. 478 (E.D.Ark.1975). In Arkansas, that standard is deemed satisfied when the proponent produces " . . . evidence by a credible witness whose memory of facts about which he testifies is distinct and whose narration of details thereof is exact and in due order and whose testimony is so clear, direct, weighty, and convincing as to enable the factfinder to come to a clear conviction, without hesitancy, of the truth of the facts related . . . " *Kelly v. Kelly*, 264 Ark. 865, 575 S.W.2d 672 (1979).

A defendant's credibility is critical in an action based on fraud. If the plaintiff were required to disclose in his first pleading every circumstance grounding his belief that he has been defrauded, a wrongdoer would be apprised of the identity of plaintiff's sources and the extent to which he has secured documentation for his belief. Such a wrongdoer would be given an opportunity

in advance of oral discovery to begin fashioning testimony to explain apparent contradictions. Counsel experienced in fraud litigation well know the vital importance of committing defendants to completely impeachable accounts of their actions and motives. If the defendant is completely informed of the materials in his opponent's possession, the best efforts of counsel to ensnare him in a web of his own deceits will be for naught.

In saying this, the court does not presume that any fraud has been practiced by any of these defendants. It bears notice, however, that the innocent fraud defendant stands to gain nothing more than a general litigation advantage from a requirement that the plaintiff detail every circumstance giving rise to his belief that he has been defrauded. The truly injured plaintiff, on the other hand, stands to forfeit whatever chance of success he holds against the heavy odds laid down by the clear and convincing standard of proof in his case. Pleading rules should not be read to demand a level of particularity that only makes a complaint prolix, at great cost to the plaintiff, and with no special benefit running toward the honest defendant, whom Rule 9(f) is designed to aid.

For the reasons indicated above, the court believes that the complaint sufficiently alleges both fraud and reliance (Consolidated Complaint, Para. 68). The court would note plaintiffs' suggestion that reliance may be presumed in cases such as this one. This may well be the law in other jurisdictions. *Zatkin v. Primuth*, 551 F.Supp. 39 (S.D.Cal.1982). But in Arkansas, fraud is never presumed. *Donovan Construction Co. v. Woolsey*, 358 F.Supp. 375 (W.D.Ark.1973). Whether reliance *as an element* of fraud may be presumed as plaintiffs suggest is an open

question, unnecessary to be resolved since the court believes for present purposes it has been sufficiently alleged.

The court notes that the complaint does not, for example, specifically state that Moody's determination to treat demand note funds as long-term liabilities either induced a party to buy the notes, or persuaded him to forebear from selling them when a prudent investor would have done so were he fully advised of the facts. If an auditor owes fiduciary duties to a corporation [and the court does not now decide that they do, *but see, Investors Funding Corp. of N.Y. Sec. Lit.*, 523 F.Supp. 533, 542, n. 4 (S.D.N.Y.1980)] then actionable fraud would exist not only as to positive deceit, but also where the fiduciary failed to disclose important facts, a situation where reliance is *inferred* rather than proved. Furthermore, reckless conduct freely substitutes as sufficient evidence of fraud in fiduciary contexts. Moody's reckless failure to inform the Co-op that the entity was nearly insolvent, and lacked sufficient current assets to retire the demand notes when "due", might very well make out a submissible case of fraud under such a theory.

The complaint is therefore dismissed as to the class and sustained as to the Co-op.

COUNT III: SECURITIES FRAUD IN TRANSFERRING WHITE FLAME TO THE CO-OP

Count III charges White, his related enterprises, Kuykendall, Co-op directors, Ball and Mourton, Goradia, Creekmore, and Harriman with securities fraud in transferring White Flame stock to the Co-op. The complaint

alleges that the transaction violated the Securities Exchange Act of 1934 and the Arkansas securities fraud statute. The complaint states a cause of action under both the federal and state law. However, inasmuch as the Co-op, and the Co-op alone was the "buyer", the complaint does not state a cause of action on behalf of the members and patronage dividend holders.

COUNT IV: WRONGFULLY PROLONGING OPERATION OF THE CO-OP AND MISLEADING GOVERNMENT AUTHORITIES

Count IV seeks damages for the Co-op and the class against essentially all of the defendants for negligence and fraud in prolonging the existence of the Co-op after insolvency. (Para. 53, Consolidated Complaint). *See, Schacht v. Brown*, 711 F.2d 1343 (7th Cir.), *cert. denied*, 464 U.S. 1002, 104 S.Ct. 509, 78 L.Ed.2d 698 (1983). This count of the consolidated complaint may proceed on behalf of the Co-op and the class because even though the pleading specifies a common core of negligent/fraudulent acts, the damages sustained by the class are different from those alleged to have been suffered by the Co-op. The operation of a corporation beyond the point of its insolvency works a fraud upon creditors and investors, at least to the extent that they have been misinformed as to the true status of the corporation's affairs. The consolidated complaint (at Para. 67) alleges, for example, that the Arthur Young defendant knew that class members, largely elderly unsophisticated parties, were investing millions of dollars in the Co-op on the strength of audits by Arthur Young which had been "condensed" to a point where they failed to show that which the Arthur Young partners knew to be

the case: that the company faced a "high probability of bankruptcy." Had the investors been correctly informed, they would either have refrained from transferring their savings to the uninsured Co-op, or they would have taken steps to withdraw their moneys from the corporation. As a result, the class is said to have lost the value of investments made after February 14, 1980 (Consolidated Complaint, Para. 107).

The Co-op, on the other hand, is said to have lost moneys by virtue of the fact that the artificial prolongation of its existence disabled officers, directors, and/or members from taking action to redress wrongs done to it; that it continued to incur liabilities beyond a time when it could have managed to absorb them, deepening the damages to its fisc; and that it became a helpless victim of further looting throughout its insolvency, whereas if it had been in receivership, its assets would have been saved rather than squandered. (Consolidated Complaint, Para. 106). One thinks, in this connection, of the $1.8 million spent by the Co-op to operate the defunct White Flame plaint after it was officially transferred to the Co-op by White. [Consolidated Complaint, Para. 44(b)].

The plaintiffs, then, were injured *severally* by the acts of the defendants in prolonging the existence of the corporation. This is not a case where the Co-op, principally, was injured, and therefore its members and shareholders were affected. Instead, the investors were injured by being induced to become members of the "class". Not to put too fine a point on it, the investors theoretically have a cause of action *against* the Co-op for issuing demand notes to them. The Co-op has no power to sue for damages it caused. The essential distinction between those

damages sought in Counts I, II, and III, where the court has disallowed the class from proceeding, and those sought in this count, where the class may present its complaint, is that in the former instance, all damages directly affected the Co-op, and no such direct effect visited the class; whereas in the latter instance, class members have suffered damages unique to themselves, losses which the Trustee could not claim because he represents an entity *actually adverse* to the class insofar as their claim in concerned.

The consolidated complaint alleges that the negligence of certain accountants and lawyers damaged the class by presenting an image of financial salubrity, when in fact the Co-op was practically bankrupt if not actually insolvent. At issue, then, is the liability of professional advisers to the investing public for negligent misrepresentations presented in financial reports, audits, etc. As a general rule, an accountant is liable to persons not in privity with him only for fraudulent misrepresentations, not for negligent ones. *Ultramares Corp. v. Touche,* 255 N.Y. 170, 174 N.E. 441 (1931). This decision is somewhat of an anomaly: it was written at a time when the "citadel of privity" had been breached on nearly all sides, chiefly because of the work of Justice Cardozo, who authored the *Ultramares* "exception." This limitation on general negligence liability has survived numerous subsequent challenges, although recently third parties have enjoyed a limited measure of success. *See, e.g., Zatkin v. Primuth,* 551 F.Supp. 39 (S.D.Cal.1973); *Ingram Industries v. Nowicki,* 527 F.Supp. 683 (E.D.Ky.1981). "Academic" opinion, *viz.* Restatement 2d Torts, Sec. 552, is hostile to the *Ultramares* limitation. It is said in short that the "better" or "more

progressive" rule of law is to abandon the privity defense in cases where a professional has negligently advised his client, resulting in damages to third parties.

This court does not conceive its duty to be to apply so-called "more modern" rules of law in diversity cases; rather, it believes that it should apply the rule which Arkansas courts would most probably use to determine a conflict. First, the American Law Institute, which sponsors the Restatement 2d Torts, is a learned body, but not a governing one. It is unaccountable to the political process. There was sparse curial support for the Institute's determination that liability should attach even in the absence of privity. In fact, there was none. This court hesitates to follow the lead of plaintiffs' counsel who argue that duties be created to favor remote parties because for example, of the "availaibility of insurance" to cover the risk. It seems to the court that this make-weight argument really stands the entire question on its head. The standard of behavior ultimately being enforced in such a case is a "duty to buy insurance". Given the currently and widely expressed concerns among Arkansas legislators about the availability and cost of business insurance (*see,* Arkansas Gazette, March 17, 1986, p. 3) and their growing determination to act legislatively in this very area, either by limiting the kinds of claims that might be presented or by adjusting the premiums which might be charged, this court feels that it is most inappropriate for it to be creating "new torts" at this time, and declines to pronounce liability in the absence of strong signals from our state courts that they would do so.

Second, such "stong signals" are absent in this instance. In fact, to the extent that such a case was ever presented in Arkansas, a federal court sitting in diversity determined *sub silentio* that negligence was not the appropriate standard of behavior to measure the duty of care running from an accountant to a third party relying on his audit. *Donovan Construction Co. v. Woolsey,* 358 F.Supp. 375, 383 (W.D.Ark.1973). In fact, it is a general rule of Arkansas contract law, (except in sales of goods), that consequential damages for faulty performance are strictly limited to those which necessarily flow from the breach, or which were tacitly agreed-to by the breaching party. Note, "Tacit Agreement Rule Reaffirmed in Contract Cases in Arkansas," 32 Ark.L.Rev.139 (1978). This rule is not direct or compelling authority for the court's position on this issue. Rather, the rule obliquely supports the court's determination in this way: the contractual relation ship is initially consensual, and the Arkansas courts conceive that the relationship maintains its consensual character throughout, even to the point of holding that a breaching party must be found to have "assented to such a liability" before he might be charged with consequential damages for his breach. *See, Hooks Smelting Co. v. Planters Compress Co.,* 72 Ark. 275, 286, 79 S.W. 1052, 1086 (1904). As the Arkansas Law Review note suggests, Arkansas has held to this minority position even in the face of its decline elsewhere in the country. This court would find it hard to believe that Arkansas would broaden tort liability to innumerable third parties arising out of a contractual relationship, while it retains a strict limitation *vis a vis* the extent and kind of contractual remedies available to the parties in privity.

Finally, even if the court were inclined to allow third parties relief for negligent misrepresentations, it would not do so in this case. Those jurisdictions allowing third parties relief in cases such as these have done so where small numbers of plaintiffs comprise the class. The court understands that there are upwards of 23,000 persons in the plaintiff class, several thousand of whom are holders of demand notes. This class is simply too large even for the more modern theory of liability suggested by Restatement 2d Torts Sec. 552.

This means, in sum, that that part of the class' complaint charging negligence will be dismissed. The class may pursue its action grounded in fraud, or such gross negligence as amounts to fraud. The Co-op may ground its action in negligence or fraud, since it enjoys privity of contract with its professional advisers.

COUNT V: BREACH OF CONTRACT BY ACCOUNTANTS

The motions to dismiss filed by all lawyers and accountants ask the court to find that Arkansas law holds that no cause of action may be maintained against them for breach of contract, where the gist of the complaint is that the defendant badly performed his contractual duties. The defendants insist that such a complaint sounds exclusively in tort.

The considerable pleading and briefing on this point impels the court to conclude that this is no mere academic point. The court suspects that plaintiffs fear that if

they are forced into a cause of action sounding in negligence, they will face defenses, i.e., contributory negligence, not ordinarily available to all action on a contract. Additionally, certain facts clustering around the general rubric of fraud and deceit require the plaintiff to plead and prove that he relied on the misrepresentation. Of course, if the plaintiff has bargained and won a contractual promise that certain representations are true, then the issue of reliance falls from the case, with exceptions not relevant for this discussion.

If indeed that is an accurate statement of plaintiffs' fears (and defendants' hopes) then both may underestimate the flexibility of tort law to deal with the very special problems of negligent performance within the consensual environment of the professional relationship. Contributory negligence, for example, is commonly invoked to reduce or bar a negligent plaintiff's recovery in a traffic mishap. In the case of an audit which fails to disclose embezzlement by an employee, it is superficially appealing to suggest that the employer may be principally at fault for his losses for having failed on his own to detect the dishonesty, or in having hired an untrustworthy clerk in the first place. Yet, courts dealing with this problem have had little difficulty penetrating such an argument. *See, e.g., Lincoln Grain, Inc. v. Coopers & Lybrand,* 216 Neb. 433, 345 N.W.2d 300 (1984). Interestingly, the resolution reached by *Lincoln Grain* – that the contributory negligence of the audited client is a defense only where it has contributed to the accountant's failure to perform the contract – bears strong resemblance to the contract doctrine that one is not responsible for his failure

to perform if he was frustrated in doing so by the plaintiff.

This court cannot forecast what problems may arise from its decision on this question. Understandably, therefore, the court is loathe to make "outcome determinative" decisions on the basis of the pleadings. Nevertheless, if the law of Arkansas does not allow an action to proceed in contract against a lawyer or accountant charged with misfeasance in the course of his services, then this court would be remiss in not acting promptly on the motion. The estate and the defendants would squander valuable discovery time and resources on contract issues which may not properly be submissible to a jury. Given the staggering legal fees generated by this action, it is also uneconomic to invite later motions for summary judgment if, indeed, *no* set of facts can ever be developed which would permit an issue to be given to a jury under a set of instructions embodying contract theories.

Defendants claim, and indeed it appears, that the complaint recites that the accountants performed their services *badly*, not that they simply failed to perform them at all. Furthermore, the contracts between the auditors and the Co-op do not appear to contain any special engagements beyond the promise to audit the books and prepare the tax returns. By "special engagements" we are referring, for example, to a promise to perform the services within a particular time. If such a special promise were present, and such a promise were not part and parcel of a general duty to use reasonable care in the rendition of professional services, then an entirely different question would be presented concerning the applicability of tort on contract law. *See, e.g., L.B. Laboratories,*

Inc. v. Mitchell, 39 Cal.2d 56, 244 P.2d 385 (1952). Such a case does not appear on the state of the pleadings, and instead we are brought again to the question whether a professional's failure to observe a given standard of care in his services may be heard in contract.

The plaintiffs have cited five Arkansas cases for the proposition that one may sue an accountant or lawyer, in tort or contract, for the negligent performance of the duties: *Dorr v. Fike,* 177 Ark. 907, 9 S.W.2d 318 (1928); *Derby v. Blankenship,* 217 Ark. 272, 230 S.W.2d 481 (1950); *Midwest Mutual Ins. Co. v. Arkansas National Co.,* 260 Ark. 352, 538 S.W.2d 574 (1976); *Lawrence v. Francis,* 223 Ark. 584, 267 S.W.2d 306 (1954); *Rhine v. Haley,* 238 Ark. 72, 378 S.W.2d 655 (1964); and *Red Lobster Inns, Inc. v. Lawyers Title Ins. Corp.,* 492 F.Supp. 933 (E.D.Ark. 1980), *aff'd in part and rev'd other grounds,* 656 F.2d 381 (8th Cir.1981). The first case, *Dorr v. Fike, supra,* simply has no bearing on the matter at all. Its only relevance to the discussion is a mention in passing that a physician impliedly contracts that he will treat a patient with due care. It does not purport to answer whether a concurrent remedy for breach of that duty sounds in contract.

In citing *Derby v. Blankenship, supra,* plaintiffs have chosen an eminent authority (Justice Leflar) but the wrong case. In that opinion, an insurance agent promised to insure his client against liability imposed by the Worker's Compensation laws, and failed to do so. The facts suggested that the client told the agent that he did not want to start his sawmill operation until the insurance was placed, and gave him a $262.50 check that day for a binder. Two to three weeks after this took place, a worker was injured, and the employee took action against

his insurance agent to recover the money owed to the worker. There is some doubt, due to the fact that consequential damages were awarded for the breach whether this action truly sounded in contract, *see,* discussion of "tacit agreement" rule *supra,* at Count 4, and *infra.* That is, the damages recovered by the employee were not such as are in Arkansas ordinarily recoverable for breach of contract.

Be that as it may, the opinion appears to read as though the action were maintained in contract. This presents no problem, though, because the defendant did *not* perform his promise; that is, the essence of the action lay in defendant's utter failure to perform. As previously indicated, and as will later be developed, the failure to perform a promise implied in a professional relationship sounds in contract, rather than in tort. Finally, the court questions the applicability of the law regulating commercial relationships between a customer and his insurance agent to a situation involving the rendition of professional services.

To the same effect as *Derby* are *Midwest Mutual Ins. Co. v. Arkansas National Co.,* 260 Ark. 352, 538 S.W.2d 574 (1976); and *Lawrence v. Francis,* 223 Ark. 584, 267 S.W.2d 306 (1954), except that in *Midwest Mutual, supra,* the parties stipulated that the action was one in tort. That itself made any discussion of contract theories superfluous, except insofar as a discussion of contract law is inevitable whenever tortious misfeasance upsets an initially consensual relationship.

In *Rhine v. Haley, supra,* both nonfeasance and misfeasance appeared in one case, under two separate engagements. Mrs. Haley hired lawyer Rhine to protect her

interests in a divorce case against Dr. Haley, who, at the time the action against her attorney commenced, lived in parts unknown with his second wife. Mrs. Haley charged that Rhine was initially negligent in failing to provide security for her debts under a property settlement agreement. When the doctor departed, she held only his I.O.U. She further charged that after the decree was entered and before the doctor left, she engaged Rhine to collect her debts from Dr. Haley, and that Rhine did nothing. This breached the contract by non-performance. This court does not suggest that *all* the confusion wrought by *Rhine v. Haley* stems from this circumstance, but certainly some of it does. The impressive aspect of *Rhine* is that even where both misfeasance and nonfeasance in the context of two different professional engagements are alleged, the Supreme Court treated them not as sounding either in tort or contract, but in tort alone! This is the impact both of the award of tort damages in the case, which was affirmed *sub silentio,* and of the opinion's statement, 238 Ark. at 85, 378 S.W.2d 655, that "Although [Mrs. Haley's] claim against [Dr. Haley] was on contract, her claim against [lawyer Rhine] was in tort, on the theory that [he] was guilty of negligence." This case is particularly slim authority for the proposition that one may sue his accountant either in tort or contract for misfeasance; indeed, the case strongly suggests that no contract action is allowed, without, of course, so holding.

Finally, the plaintiff suggests that *dicta* in *Red Lobster Inns v. Lawyers Title Ins. Corp., supra,* supports its argument that a cause of action in contract may lie against a negligent professional. One familiar with

Arkansas law may strongly infer that plaintiff Red Lobster urged the court to allow its action to proceed in tort, whereas defendant Lawyers Title wanted the action to be heard in contract. By way of background, Red Lobster contracted with Lawyers Title to abstract properties it desired to buy, and as a special engagement under that contract, desired that it be informed of any use restrictions that would disable it from operating a restaurant in a particular location. Lawyers Title failed to abstract a "no restaurant" covenant in a prior deed, and as a result, Red Lobster was delayed in opening some five or six months, and therefore lost profits of $78,000 or so. As previously stated Arkansas law holds that before a defendant may be held liable for special damages such as loss of profits, it must appear that at the time of the contract he knew of the special circumstances out of which the damages would arise, and furthermore, that he tacitly agreed to be bound to more than ordinary damages in case of default on his part. *Hawkins v. Delta Spindle of Blytheville,* 245 Ark. 830, 835-36, 434 S.W.2d 825 (1968). This holding was recently re-affirmed in *Bānkston v. Pulaski County School District,* 281 Ark. 476, 480, 665 S.W.2d 859 (1984). Consequently, the Red Lobster plaintiff did not want his case in contract, since such a sounding would limit his damages to, at most, the diminished value of the property, probably a few thousand dollars at most. Judge Woods held that he might sue in tort.

Furthermore, to the extent that *Red Lobster* could ever be considered a contract case, it would be so considered because of a factor not present on the face of those pleadings: the Red Lobster pleadings contained a "special engagement", *i.e.* to search for and report all relevant use

restrictions on the subject properties. This duty was expressly contractual, and existed separate and apart from any general duty of ordinary care implied by law. To the extent, then, that *Red Lobster* allowed a plaintiff to sue for the non-performance of a special engagement in tort, rather than confining his remedy to contract, the defendants' position on this motion is bolstered rather than weakened.

Defendants argued, the magistrate opined, and the plaintiffs do not really seem to contest that the "majority rule" and "better rule of law" is that misfeasance in the context of a contract for professional services sounds exclusively in tort, *see Cherokee Restaurant, Inc. v. Puisar,* 428 So.2d 995, 997-98 (La.App.1983). As mentioned, plaintiff suggests on the strength of the five cases treated above that concurrent remedies are all allowed in this state. The foregoing discussion of these precedents leaves the court unconvinced that Arkansas departs from the majority rule.

Whether an action may be allowed to proceed in tort or contract is an issue relicted from days of your when barristers fought pleading wars under the old forms of action. As Judge Arnold of our district, quoting Lord Raymond, C.J., in *Reynolds v. Clark* (1725) 1 Strange 634, at 635 said: "It was deemed necessary to 'keep up the boundaries of actions' or the unthinkable would happen: 'we shall introduce the utmost confusion.' " Arnold, *Select Cases of Trespass from the King's Courts 1307-1399,* London, Selden Society, 1985, ix, n. 1. The court has considerable sympathy for Lord Raymond, indeed for Chicken Littles everywhere, having worked through the arguments and authorities advanced by counsel. Today's

case bears pleasing witness to the progress we as a people have made in streamlining the litigation process over the past two-and-a-half centuries. What formerly would have taken over a year – *i.e.*, to require a validly served defendant to answer over after demurrers, traverses, etc., etc. – now only takes thirteen months or so. "The forms of action are dead," said Maitland, "but they rule us from the grave."

Perhaps in an attempt to undo the sort of confusion that obtains when arguments erupt over whether a suit may "sound" in tort or contract or both, the Arkansas Supreme Court has said, in *Atkins Pickle Co. v. Burrough-Uehrling-Brassuell*, 275 Ark. 135, 138, 628 S.W.2d 9 (1982): "The purpose of the law of contracts is to see that promises are performed; the law of torts provides redress for various injuries . . . "

It appears in this case that the plaintiff's complaint protests the injury caused by bad performance more so than the failure to embark upon a promised course of performance. The complaint therefore sounds in tort, and not in contract, *see, e.g., Miller v. Mintorn*, 83 Ark. 918 (1904).

COUNT VI: VIOLATION OF FEDERAL AND STATE SECURITIES LAWS

The sixth count of the consolidated complaint charges the defendants with state and federal securities laws violations. The count asks for damages on behalf of both the class and the Co-op. The court has initial difficulty understanding how the Co-op can be an injured party in a securities fraud case.

First, the complaint generally alleges that with respect to the sale of the Co-op demand notes, the purchasers were defrauded by being told that the corporation's financial picture was healthier than it was. An investor might very well be willing to invest his funds at 6 or 7% in a sound and healthy institution, but if he were asked to entrust his money in an insolvent or nearly insolvent business, he might require a very much higher rate of return on his money, or he might forego entirely investing in the enterprise. Under this analysis, the Co-op *actually profited* from the sale of demand notes, since it acquired capital at a much cheaper price than it would have to pay in an arm's length, market transaction, stripped of fraud.

The plaintiffs suggest that the Co-op was artificially maintained in its existence by White *et al* so that White could loot the company, and thereby suffered damage. If so, the damages were not suffered "in connection with" the purchase or sale of a security. They happened *subsequent to* the sale, and not even as a result of the sale. For this reason, a cause of action for the Co-op for violation of Section 10, and Rule 10(b)(5) of the Securities Exchange Act of 1934 must be dismissed. The Co-op suffered no damage "in connection with" the transaction; to the extent that it later became arguably liable for damages to shareholders and investors, this damage was not suffered in connection with the sale. *See, generally, In re Investors Funding Corporation of New York Securities Litigation,* 523 F.Supp. 533, 539-40 (S.D.N.Y.1981).

The Securities Act of 1933 prohibits a party from selling unregistered securities through the mails or in

interstate commerce, or those without qualifying prospectuses. 15 U.S.C. Sec. 77e. In the event that such a security is *sold* without registration on prospectus, the buyer may, at his election, sue to recover *the consideration paid* for such security. 15 U.S.C. Sec. 77*l*. The complaint does not allege that the Co-op bought securities, or that it suffered any damage from buying the securities. Therefore, the Co-op would be limited by the language of 15 U.S.C. Sec. 77*l*(2) to recovering the consideration paid less any income received, plus interest. If he no longer *owns* the security, he may sue for damages.

The Co-op asks damages for *indemnification* on the theory that *if* the class plaintiffs are successful in "rescinding" the transactions under federal law they will *owe* the plaintiffs the amount invested plus interest, or under state law the amount owed plus six percent interest. Ark.Stat.Ann.Sec. 67-1256 (1980 Repl.). That is, the Co-op complains that it will have to pay, as damages, less than it would have had to pay for the use of the money if it had applied for it through normal commercial channels. There can be no question but that all funds collected by the Co-op were used by it for corporate purposes, except perhaps those "looted" by White and White-related enterprises in "sweetheart deals" (Par. 47-49). If these "demand notes" did *not* contain on their face an unconditional promise to repay the amounts advanced with interest – if in short they were a typical speculative security in which the investor takes a risk that stock prices will "fall" – then the court could have more sympathy with the concept that the Co-op had suffered injury from the acts of the defendants. That is, the Co-op *by law* would be obliged to pay an amount of money, because its directors

sold unregistered stock, which it would not otherwise have been obliged to pay under its contract with its shareholder. But in this case, the Co-op's contract with its investor specifies that *it will* pay the face amount of the note, plus interest. The Securities Act of 1933 adds nothing to the Co-op's liability than that which it had already agreed to assume at the moment the note was issued. For reasons discussed generally in *Cenco, Inc. v. Seidman & Seidman*, 686 F.2d 449, (7th Cir.1982), the court believes that the Co-op has not, under the pleadings, suffered injury or damage as a result of these acts, and that its cause of action should therefore be dismissed; alternatively, the Co-op, as a "seller" does not have a cause of action under the Securities Act of 1933, and its damages, if any, were not suffered "in connection with" the sale of a security under Sec. 10 and Rule 10(b)(5) of the Securities Exchange Act of 1934.

With respect to the class's claims under federal and state securities laws, the court is aware of the contentions by the defendants that the Co-op demand notes are not "securities" within the meaning of the statutes. The court is open to argument on this point, but not at this time. The statutes all define a "security" as a "note" or "evidence of indebtedness," 15 U.S.C. Sec. 77b(*l*), 15 U.S.C. Sec. 78c(a)(10), Ark.Stats.Ann.Sec. 67-1256 (1980 Repl.). The court can certainly appreciate how the legislatures might very well conclude that a broad-scale, uninsured, unregulated investment program such as the Co-op offered requires a measure of protection for the public such as might be obtained through registration, with an civil liability imposed for fraud or misleading statements,

as well as failure to submit one's self to registration and oversight.

The court will therefore overrule the defendant's objections to Count VI of the Complaint, saying that the class states a cause of action against the defendants. The court will reserve for summary judgment any questions defendants may wish to raise concerning the applicability of the statutes to the demand note program, the individual liability of defendants cited by the Complaint (*i.e.*, Rimmer) and limitations questions – as well, of course, as any questions which the parties otherwise feel resolvable by summary judgment. The record is not developed to the point that the court feels confident that matters as grave as these can be resolved in summary fashion at the pleading stage.

COUNTS VII & VIII: FRAUDS, MISREPRESENTATIONS AND BREACHES OF FIDUCIARY DUTIES

Counts seven and eight charge that Ball and Mourton constructively defrauded the Co-op by representing both it and Jack White, and assisting him in transferring White Flame to the Co-op and releasing him from his $4 million obligation on notes guaranteed by him between January and December, 1980. As discussed in Count I, *supra,* these causes of action belong to the Co-op and not to the class. They will therefore be dismissed as to the class. The Co-op will be allowed to proceed on these causes of action in its own name.

COUNT IX: CITIZENS BANK CAUSE OF ACTION

This matter is moot and awaits presentation of apt orders from counsel from the Co-op and the Citizens Bank of Van Buren.

COUNTS X & XI: NEGLIGENCE BY DIRECTORS AND ATTORNEYS

Count X charges negligent, but non-fraudulent, directors with damages suffered by the Co-op as a result of mismanagement; Count XI charges the Co-op's attorneys (Ball and Mourton, Creekmore and Harriman) with negligently advising the Co-op in the conduct of its affairs. These counts may only be asserted by the Co-op, not the class, for reasons discussed in the discussion of this issue in Count I, above. The class claims will be dismissed; the Co-op will be allowed to proceed, subject to any future motions for summary judgment regarding the statute of limitations, etc.

COUNT XII

In Count XII, the Co-op and the class assert a claim against the attorneys for breach of contract by negligent performance. For reasons advanced in the discussion with respect to Count V, this cause of action is dismissed as to both the Co-op and the class.

COUNT XIII

The plaintiffs' cause of action embodied in Count XIII of the consolidated complaint charges all defendants with

R.I.C.O. violations causing damage to the Co-op and the class. The R.I.C.O. pleading appears to identify February, 1980, as the starting point of the scheme to defraud (Par. 160). This would coincide with the "back dated" sale of White Flame to the Co-op, or the approximate point at which the Co-op began making unauthorized loans to White to enable him to operate the gasohol plant, loans which ultimately totaled $4 million before they were finally "forgiven" in the Chancery Court action.

The plaintiffs allege that the defendants, through a pattern of racketeering activity, damaged the Co-op by foisting off on it a worthless asset driving it into insolvency. At the point of insolvency, the fraud, which initially operated against the Co-op's interest alone, began to inflict damage on the demand note holders who extended credit to the entity based on the representation that their funds were safely placed with a solvent and trustworthy enterprise.

The alleged R.I.C.O. violations, then, had serial victims: first the Co-op, then the noteholders, whose capital was needed to allow the Co-op to proceed in business so that the perpetrators of the initial fraud could better conceal their actions. As the court has noted in its discussion of Count VI (the allegation of securities fraud) at the point of insolvency the Co-op became an engine of fraud, not a victim of fraud. The demand note program permitted the Co-op access to capital at a lower rate of interest than it would have been able to get in the market, and this was so, according to the complaint, because the Co-op successfully misrepresented its condition to the noteholders.

Counsel for Moody has argued that the class may not prosecute a R.I.C.O. claim in addition to the one prosecuted by the trustee. *Carter v. Berger,* 777 F.2d 1173 (7th Cir.1985). The situation in *Carter* was quite different, however. The damages to the class did not necessarily result from damages to the defrauded entity, *see* 777 F.2d at 1177. Even if they did, the court adopted the "passing on" rule of the antitrust law to allow only the directly injured party to sue. *Cf. Illinois Brick v. Illinois,* 431 U.S. 720, 97 S.Ct. 2061, 52 L.Ed.2d 707 (1977).

Here the damages are totally distinct, and with respect to the use of the mails to solicit or defraud in the context of demand note investments, class members are the only "injured party" and therefore the "real party in interest" for such damages under F.R.C.P., Rule 17(a).

A number of other objections have been presented by various defendants with respect to the R.I.C.O. claims. Accountant and lawyer defendants have disputed the assertion that they "controlled" the Co-op so as to defraud any class members, *citing Bennet v. Berg,* 685 F.2d 1053 (8th Cir. 1982). On remand, the district court in *Bennet v. Berg,* 80-381-CV-W-O (W.D.Mo. June 21, 1984) found the requisite "control" existed under the amended pleadings. This court does not feel bound by that resolution in any sense. It merely notes that "an argument" can be made that non-directors and non-employees of an enterprise can "control" it. In this case, the pleadings make more than an argument that lawyers, for example, controlled the affairs of the Co-op enterprise. The complaint alleges that White "dominated" the Board, and that his lawyers (who were also the Co-op's lawyers) drew up the pleadings which foisted White Flame off on the Co-

op. The complaint alleges that this was a $4-7 million transaction, a quite sizeable one relative to the total assets of the Co-op. It could not have been finalized "but for" the activities of the lawyers in concert with White, a dominating party. The complaint alleges sufficient control over the Co-op through White to take plaintiffs past the pleading stage *vis a vis* the attorneys. Similar, albeit not as forceful arguments can be made with respect to the accountants.

In short, the court believes that the complaint states a R.I.C.O. cause of action against the defendants. Defendants wishing to submit summary judgment arguments on issues such as "control" or "aiding" or limitations, etc., are certainly invited to do so. To dismiss the complaint at this point, however, would in many if not all cases be giving ear to speaking demurrers. Because the complaint adequately states a cause of action against all defendants, their motions are overruled.

COUNT XIV: VIOLATION OF "LITTLE FTC" AND CONSUMER PROTECTION ACTS

Count XIV alleges that defendants violated the Consumer Protection Acts of Arkansas and Oklahoma by selling the demand notes by means of misrepresentations. Ark.Stat.Ann.Sec. 70-913 removes from the purview of the Consumer Protection Act those transactions governed by the State Commissioner of Securities. The Arkansas statute, therefore, has no application to this situation.

The Oklahoma Statute does not contain the same language as Arkansas'. The court is convinced, though,

that it does not apply. Indeed, only the rare state consumer protection statute concerns itself with sales of securities. *See, Swenson v. Englestad,* 626 F.2d 421 (5th Cir.1980) (stock certificates not "goods or tangible chattels" under Texas act.)

To the extent that the state acts may be seen as prohibiting lawyers and accountants from "any deception, fraud . . . in connection with the sale or advertisement of any goods or services," *see* Ark.Stat.Ann.Sec. 70-904, the complaint is void of any allegation that any lawyer or accountant fraudulently induced the Co-op to secure his services. Alternatively, the court believes that this statute was not designed to regulate the lawyer-client or accountant-client relationship.

In short, all causes of action, whether raised by the Co-op or the class, brought under the consumer protection acts of Arkansas or Oklahoma will be dismissed.

COUNT XV: VIOLATION OF ARKANSAS CRIMINAL CODE

The law of Arkansas does not imply a private right of action for violation of misdemeanor statutes. Ark.Stat.Ann.Sec. 41-2307 (1977 Repl.) which criminalizes the offense of receiving deposits in a failing financial institution, has no application to the facts alleged in the complaint, which recites that the Co-op is a "co-operative corporation" (Par. 1), not a financial institution.

COUNT XVI: TRANSFERS BY INSOLVENT IN VIOLATION OF ARKANSAS COMMON LAW

This cause of action seeks to avoid all transfers which caused the Co-op to become insolvent. The count infers that the White Flame transfer is mentioned in this context. The court is inclined to dismiss this cause of action, since it is reliably informed that the trustee has filed suit against the architects, designers, builders, etc. of the White Flame plant for breach of warranty, etc. The court views such a lawsuit as amounting to a ratification of the transfer. Either this lawsuit, or the other one against A.C.R., etc., needs to be dismissed. The court will therefore dismiss this cause of action, giving plaintiffs ten days to file an amended pleading specifying which transfers, if any, it wishes to avoid, and whether such an action should be filed in bankruptcy court first, or in this court as an original matter apart from bankruptcy.

COUNT XVII: FORFEITURE OF COMPENSATION BY CO-OP OFFICERS AND DIRECTORS

This cause of action asks that Co-op officers and directors forfeit their pay because of their breach of fiduciary duties. This action may be maintained by the trustee, but not by the class.

D. SUMMARY

The court has acted to clarify which causes of action belong to whom, rather than to pass on questions of the sufficiency of pleadings which, at times, appeared conclusory on questions of "control" of an enterprise, etc.,

etc. The court's reasons were manifold. Primarily, the court hopes to prepare this lawsuit for trial in the most fair, expeditious, and efficient way possible. To require more pleading is counterproductive. This court has gone on record as supporting sanctions under Rule 11 against any party or attorney who persists in keeping a party in a lawsuit, or maintaining a spurious defense, after it has become apparent through discovery that the claim or defense is no longer justified by the evidence. The court trusts that the parties will examine their case with this admonition in mind, and make whatever adjustments as will further promote the orderly resolution of this dispute.